

No. 89-1149-CFX  
Status: GRANTED

Title: Coy R. Grogan, et al., Petitioners  
v.  
Frank J. Garner, Jr.

Docketed:  
December 11, 1989

Court: United States Court of Appeals  
for the Eighth Circuit

See also:  
90-389

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Entry	Date	Note	Proceedings and Orders
1	Dec 11 1989	G	Petition for writ of certiorari filed.
2	Feb 21 1990		DISTRIBUTED. March 16, 1990
3	Mar 8 1990	P	Response requested -- TM, JPS. (Due April 7, 1990)
4	Apr 4 1990		Brief of respondent Frank J. Garner in opposition filed.
5	Apr 11 1990		REDISTRIBUTED. April 27, 1990
6	Apr 30 1990		Petition GRANTED. *****
8	May 31 1990		Order extending time to file brief of petitioner on the merits until July 3, 1990.
9	Jul 3 1990		Joint appendix filed.
10	Jul 3 1990		Brief amici curiae of United States, et al. filed.
11	Jul 3 1990		Brief of petitioners Coy R. Grogan, et al. filed.
15	Jul 12 1990	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
12	Aug 6 1990		Brief of respondent Garner filed.
14	Aug 27 1990		Record filed.
		*	Certified copy of original record, box, received.
13	Aug 28 1990		CIRCULATED.
16	Aug 30 1990		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
17	Sep 7 1990	X	Reply brief of petitioners Coy R. Grogan, et al. filed.
18	Sep 26 1990		SET FOR ARGUMENT MONDAY, OCTOBER 29, 1990. (3RD CASE)
19	Sep 26 1990		SET FOR ARGUMENT MONDAY, OCTOBER 29, 1990. (3RD CASE)
20	Oct 11 1990	D	Motion of the Solicitor General for leave to permit Robert A. Long, Jr., Esquire, to present oral argument pro hac vice filed.
21	Oct 29 1990		Motion of the Solicitor General for leave to permit Robert A. Long, Jr., Esquire, to present oral argument pro hac vice DENIED.
22	Oct 29 1990		ARGUED.

89-1149

Supreme Court, U.S.

FILED

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CLERK

NO. \_\_\_\_\_

IN THE SUPREME COURT  
OF THE UNITED STATES

OCTOBER TERM, 1989

COY R. GROGAN and  
JOHN H. HENSON, Petitioners,

v.

FRANK J. GARNER, JR., Respondent.

PETITION FOR WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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## QUESTION PRESENTED

1. Must exceptions to discharge under Bankruptcy Code Section 523(a) be proven by the "preponderance of the evidence" standard or by the "clear and convincing evidence" standard?

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IN THE SUPREME COURT  
OF THE UNITED STATES

OCTOBER TERM, 1989

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COY R. GROGAN and  
JOHN H. HENSON,  
Petitioners,

v.

FRANK J. GARNER, JR.,  
Respondent.

---

PETITION FOR WRIT OF  
CERTIORARI TO THE  
UNITED STATES COURT OF  
APPEALS FOR THE  
EIGHTH CIRCUIT

---

Petitioners Coy R. Grogan and John H. Henson respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit, entered in the above-entitled proceeding on August 9, 1989.

OPINIONS BELOW

The decision of the Court of Appeals

for the Eighth Circuit denying rehearing has not been reported. It is reprinted in the appendix hereto, p. 42a, infra.

The opinion of the Court of Appeals for the Eighth Circuit has been reported at 881 F.2d 579. It is reprinted in the appendix hereto, p.1a, infra.

The decision of the United States District Court for the Western District of Missouri (Whipple, D.J.) has not been reported. It is reprinted in the appendix hereto, p. 16a, infra.

The Memorandum of Opinion and Order of the Bankruptcy Court for the Western District of Missouri (Koger, B.J.) has not been reported. It is reprinted in the appendix hereto, p.30a, infra.

JURISDICTION

The judgment of the Eighth Circuit

Court of Appeals, in respondent's favor, was entered August 9, 1989. The Eighth Circuit Court of Appeals denied a timely petition for rehearing on September 12, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

#### STATUTE INVOLVED

11 U.S.C. 523. Exceptions to Discharge.

As its provisions are lengthy, the pertinent text of this statute is set forth in the appendix hereto, p. 43a, infra.

#### STATEMENT OF THE CASE

Petitioners originally brought suit against respondent in the United States District Court for the Western District of Missouri. In that action, a jury determined that respondent had: 1) com-

mitted common law fraud, under Missouri law; 2) breached the fiduciary duty he owed to petitioners; and 3) violated section 10(b) of the Securities and Exchange Act of 1934.

The jury awarded actual damages on the above three counts and punitive damages on the fraud count.

The Eighth Circuit Court of Appeals affirmed the jury's judgment and award.

On October 21, 1985, respondent filed a Petition for Relief under Chapter 11 of the Bankruptcy Code, requesting that petitioners' judgment against him be discharged.

On May 7, 1986, petitioners filed a complaint in bankruptcy court which sought a determination that respondent's judgment debt was nondischargeable under 11 U.S.C. § 523. At the trial of this matter before Bankruptcy Judge Frank W. Koger, petitioners offered the following four

exhibits to prove, by collateral estoppel, that the judgment debt owed petitioners was nondischargeable:

- 1) A copy of petitioners' first amended complaint;
- 2) A copy of respondent's addendum to his brief to the Eighth Circuit Court of Appeals, containing the jury instructions, the verdict director, the jury verdict and the District Court judgment;
- 3) The opinion of the Eighth Circuit Court of Appeals; and,
- 4) A letter from the Eighth Circuit Court of Appeals transmitting the opinion.

Petitioners' then rested their case. Respondent presented evidence by his testimony, denying any wrongdoing whatsoever.

The Bankruptcy Court, citing Brown v. Felsen, 442 U.S. 127 (1979) as authority, concluded that "the elements to be proved under Section 523(a)(2) must be compared with the elements decided by the unanimous jury in the District Court case, and, if identical, as to content and standard, [petitioners] have borne their burden." See p. 36a, infra.

After comparing the elements to be proved under Section 523(a)(2) to the elements decided by the jury in the District Court case, as embodied in the record before it, the Bankruptcy Court concluded the elements were the same. Id. at 37a.

Further, the Bankruptcy Court addressed respondent's contention that in the District Court trial a "preponderance of the evidence" standard was applied, that a "clear and convincing evidence" standard should be

applied under section 523 and that the two standards are totally dissimilar. The Bankruptcy Court rejected respondent's contention concluding that "there is no real distinction between 'preponderance of the evidence' and 'clear and convincing' as regards Section 523 litigation." See p. 40a, infra.

Thus, the Bankruptcy Court, having determined the issues had been fully litigated and properly decided using identical standards, applied collateral estoppel to bar relitigation of the dischargeability issues.

Respondent appealed the Bankruptcy Court decision to the United States District Court for the Western District of Missouri.

District Court Judge Dean Whipple, in affirming the Bankruptcy Court's decision in petitioners' favor, stated that,

Both sides were permitted to try their case in full, the jury was instructed to render a verdict based upon the facts and the law given in the court's instructions. A re-litigation of this case in Bankruptcy Court on the identical fact issues would be to permit the party who loses at a jury trial to have a second day in court on the same issue he and his opponent were fully heard previously. If permitted, all like cases would result in duplicitous litigation resulting in an unreasonable burden on the bankruptcy court.

See p. 28a, infra.

Following the ruling of the District Court, respondent appealed to the Eighth Circuit Court of Appeals, seeking a holding that the jury's determination of fraud should have no preclusive effect on the subsequent bankruptcy proceeding under Section 523(a).

The Eighth Circuit determined that, in the underlying case, the District Court had applied Missouri substantive law and instructed the jury that the burden of proof for fraud is the preponderance of the evidence. See p. 8a, infra.

In examining the burden of proof under Section 523(a), the Eighth Circuit noted in its opinion that the Circuit Courts, and the bankruptcy courts, are in conflict on this issue. Furthermore, the Eighth Circuit stated that "[t]he burden of proof for fraud or any of the other exceptions from discharge under Section 523(a) of the Bankruptcy Code is far from clear. The Bankruptcy Code is silent as to the burden of proof necessary to establish an exception to discharge under section 523(a), including the exception for fraud." Id. at 9a.

Despite the noted conflict in the Circuit Courts and the Bankruptcy Code's silence on the issue, the Eighth Circuit determined that the burden of proof under Section 523(a) is "clear and convincing evidence" and reversed the decision of the District Court. See p. 14a infra.

#### REASONS FOR GRANTING THE WRIT

##### I

The Eighth Circuit's decision that the exceptions to discharge under Bankruptcy Code Section 523(a) require proof by the "clear and convincing evidence" standard is in error and is not supported by the statutory language, or by the legislative history, and is in direct conflict with decisions of the Fourth Circuit and other Courts.

Section 523(a), which contains the exceptions to discharge and their elements, makes no mention of the standard of proof that is to be applied in

dischargeability proceedings. The legislative history on § 523(a) is scant and likewise contains no reference to the proper standard of proof. See 1978 U.S. Code Cong. & Ad. News 5787, 6453.

The Bankruptcy Courts themselves are split on the issue of whether the proper standard of proof is "preponderance of the evidence" or "clear and convincing evidence". Compare In re Shepherd, 56 B.R. 218, 221 (W.D. Va. 1985); In re Boren, 47 B.R. 293, 295 (Bankr. W.D. Ky. 1985); In re Baiata, 12 B.R. 813, 817 (Bankr. E.D. N.Y. 1981); Sweet v. Ritter Finance Company, 263 F. Supp. 540, 543 (W.D. Va. 1967) (applying preponderance of the evidence standard) with In re Peoni, 67 B.R. 288, 290 (Bankr. S.D. Ind. 1986); Matter of Wintrow, 57 B.R. 695, 703 (Bankr. S.D. Ohio 1986); In re

Capparelli, 33 B.R. 360, 366 (Bankr. S.D. N.Y. 1983) (applying clear and convincing evidence standard).

The Circuit Courts are also in direct conflict on which standard is correct.

The Fourth Circuit has determined that the "preponderance of the evidence" standard should be applied. Combs v. Richardson, 838 F.2d 112 (4th Cir. 1988). In Combs, as in the instant case, the Court addressed the preclusive effect of a civil jury verdict in a subsequent bankruptcy proceeding. The Bankruptcy Court had determined that a jury verdict of assault against Combs prevented him from relitigating the issue of whether the judgment was grounded in a willful and malicious injury. Therefore, the bankruptcy court determined, Combs' debt to Richardson was nondischargeable under Section 523(a)(6) which states

that: "(a) A discharge under Section 727, 1141 or 1328(b) of this title does not discharge an individual debtor from any debt---(6) for willful and malicious injury by the debtor to another entity or to the property of another entity."

In affirming the decision of the bankruptcy court and dismissing Combs' contention that the "clear and convincing evidence" standard should be applied to dischargeability proceedings, the Fourth Circuit stated that:

The Bankruptcy Code is silent as to the standard of proof necessary to establish the exceptions to discharge in § 523. In the face of this silence, courts may not imply a higher standard than the preponderance standard normally applied in civil proceedings. Although the 'fresh start' philosophy of bankruptcy law requires that exceptions to discharge 'be confined to those plainly expressed,' Gleason v. Thaw, 236 U.S. 558, 562, 335 S.Ct. 287,

289, 59 L.Ed. 717 (1915), this policy does not justify judicial imposition of a heavier burden of proof on creditors seeking to have a debt determined nondischargeable under § 523(a)(6).

Combs, 838 F.2d at 116.

Four other Circuits are in conflict with the Fourth Circuit and have concurred with Eighth Circuit by holding that the standard of proof for discharge under section 523(a) is "clear and convincing evidence". In re Phillips, 804 F.2d 930, 932 (6th Cir. 1986); In re Kimzey, 761 F.2d 421, 423-24 (7th Cir. 1985); In re Black, 787 F.2d 503, 505 (10th Cir. 1986); Chrysler Credit Corp. v. Rebhan, 842 F.2d 1257, 1262 (11th Cir. 1988) and In re Hunter, 780 F.2d 1577, 1262 (11th Cir. 1986). However, the Eighth Circuit has noted the meager nature of the authority these various circuits have cited for requiring the more stringent standard of proof:

The circuits applying the clear and convincing standard have offered various explanations. All the circuits cite to various bankruptcy court decisions applying the clear and convincing standard. Two of the circuits cite to 3 Collier on Bankruptcy, ¶523.08 (15th Ed. 1989) which states without explanation that the appropriate burden of proof is the clear and convincing standard. In re Phillips, 804 F.2d 930, 932 (6th Cir. 1986); In re Black, 787 F.2d 503, 505 (10th Cir. 1986). Two of the circuits state that the clear and convincing standard is necessary to overcome the presumption of innocence. In re Black, 787 F.2d 503, 505 (10th Cir. 1986); In re Hunter, 780 F.2d 1577, 1579 (11th Cir. 1986). Three circuits offer no rationale at all for favoring the more stringent standard. Chrysler Credit Corp. v. Rebhan, 842 F.2d 1257, 1262 (11th Cir. 1988); In re Phillips, 804 F.2d 930, 932 (6th Cir. 1986); In re Kimzey, 761 F.2d 421, 423-24 (7th Cir. 1985).

See p. 11a-12a, infra.

The Eighth Circuit itself, in the instant case and in Matter of Van Horne, 823 F.2d 1285 (8th Cir. 1987), relies heavily upon the "fresh start" policy of the Bankruptcy Code for its determination that the "clear and convincing evidence" standard is the proper standard of proof under § 523(a). This "fresh start" policy provides for "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt," Brown v. Felsen, 442 U.S. at 128, quoting, Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

Here, the "fresh start" policy has been misapplied. By attempting to apply this policy to Section 523(a), the Eighth Circuit has failed to give effect to the rule that "[b]y seeking discharge, however, respondent placed the rectitude of his prior dealings

squarely in issue, for, as the Court has noted, the Act limits [the 'fresh start'] opportunity to the 'honest but unfortunate debtor,' Brown v. Felsen, 442 U.S. at 128, quoting, Local Loan Co. v. Hunt, 292 U.S. at 244.

Respondent has been found guilty of common law fraud. Surely such a determination would preclude him from being termed an "honest but unfortunate debtor." Therefore, the "fresh start" policy favored by the Eighth Circuit should not extend to respondent, thus alleviating any need to enforce a standard of proof more stringent than "preponderance of the evidence."

## II.

The Eighth Circuit's decision that the exceptions to discharge under Bankruptcy Code Section 523(a) require proof by the "clear and convincing evidence" standard is in error and, if unchanged, will eliminate the use of

collateral estoppel on the issue of dischargeability in those states which allow the enumerated discharge provisions to be proven by a preponderance of the evidence.

As noted above, there is no statutory or legislative history support for the imposition of the "clear and convincing evidence" standard on dischargeability proceedings under Section 523(a). The Circuit Courts, by applying this more stringent standard, absent legislative authority, to Section 523(a) proceedings have, in effect, created a new statutory element. Legislative drafting is obviously not within the purview of the judicial branch.

Issues of fact in civil cases are ordinarily required to be determined by the preponderance of the evidence. 37 Am Jur. 2d § 468. In addition, many states allow fraud to be proved in a civil case by a preponderance of the

evidence, "the same as any other material fact in such a case." Id. Missouri is such a state.

Other states require fraud to be determined by "clear and convincing evidence". Id. Still other states require a showing of "clear and convincing evidence" in some fraud actions and accept a showing of a "preponderance of the evidence" in other fraud actions. Id.

Furthermore, courts have held that terms such as "clear and convincing", "clear and positive", "clear, cogent and convincing", "strong, clear and convincing", et cetera, "mean only that there must be a preponderance of evidence sufficient to overcome the presumption of innocence of moral turpitude or crime, and, while the evidence must be clear and convincing,

such clear and convincing proof may be met by a preponderance of the evidence." 37 C.J.S. Fraud § 114.

Thus, it is evident that different standards are applied by the various states and often the same terminology may have a different effective meaning depending upon which jurisdiction interprets such terminology. These differing standards and interpretations support the contention that the bankruptcy courts should not impose a higher standard of proof on Section 523(a) proceedings absent clear legislative authority.

If it is determined that Section 523(a) requires proof by a "clear and convincing evidence" standard, such a determination would negate prior civil determinations, in those states which adhere to the "preponderance of the evidence standard", and require a retrial in full before the bankruptcy

court to determine issues of dischargeability. Obviously, collateral estoppel could not be utilized if it is determined the later proceeding calls for a higher standard of proof.

Such a determination would place tremendous strain upon the resources of bankruptcy courts across the nation. The large volume of cases tried each year by bankruptcy courts would be increased substantially due to the removal of collateral estoppel as a means by which to prove dischargeability or non-dischargeability.

The judicial policy in favor of collateral estoppel is clear and its applicability to dischargeability proceedings under § 523(a) (formerly Bankruptcy Act § 17) is undeniable. Brown v. Felsen, 442 U.S. at 139. As this Court has stated: "If in the course of adjudicating a state law

question, a state court should determine factual issues using standards identical to those of § 17, then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court." Id.

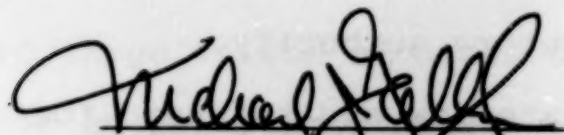
Therefore, due to the lack of contrary statutory authority, applicable state law and the need for judicial economy, a determination should be made that the "preponderance of the evidence" standard is applicable to dischargeability proceedings under section 523(a) of the Bankruptcy Code.

The determination of this Court is needed to resolve the conflict extant in the Circuit Courts of Appeals and to provide such courts guidance on this issue.

CONCLUSION

For these reasons, this Petition for Certiorari should be granted. If petitioners are correct in urging that the Eighth Circuit applied the wrong standard of proof, the decision of the District Court should be reinstated.

Respectfully submitted,



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UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

NO. 88-1991

In Re: Frank J. Garner, Jr. \*  
Debtor. \*  
John R. Henson and \*  
Coy R. Grogan, \*  
Appellees, \*  
V. \*  
Frank J. Garner, Jr., \*  
Appellant. \*

Appeal from the United States District  
Court for the Western District of Mis-  
souri

Submitted: December 13, 1988

Filed: August 9, 1989

Before HEANEY\* and FAGG, Circuit Judges, and HANSON,\*\* Senior District Judge.

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HEANEY, Circuit Judge.

This case addresses the preclusive effect of an earlier civil jury determination of fraud on a subsequent bankruptcy proceeding under section 523(a) of the Bankruptcy Code. The bankruptcy court held that the earlier trial precluded redetermination of the issue of fraud, and the district court adopted the bankruptcy court's view. We reverse because the earlier proceeding used a lesser standard of proof.

#### I. BACKGROUND

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\* The Honorable Gerald W. Heaney assumed senior status on December 31, 1988.

\*\* The HONORABLE WILLIAM C. HANSON, United States Senior District Judge for the Northern and Southern Districts of Iowa, sitting by designation.

The underlying case was tried before a jury in United States District Court for the Western District of Missouri. The jury found that Frank Garner had committed common law fraud; breached a fiduciary duty owed to the appellees; and violated section 10(b) of the Securities and Exchange Act of 1934. The jury awarded actual damages on all three counts and punitive damages on the fraud count. Garner appealed to this Court. We affirmed but reduced the amount of damages recovered. Grogan v. Garner, 806 F.2d 829 (8th Cir. 1986).

On October 21, 1985, the appellant filed a petition for relief under Chapter 11 of the Bankruptcy Code and listed the above judgment as a dischargeable debt. On May 7, 1986, the appellees filed an application for an exception to discharge, alleging

that the judgment was a debt obtained by fraud under 11 U.S.C. §523(a)(2). At trial in the bankruptcy court, the appellees presented, inter alia, the jury verdict, the district court's judgment in their favor, and rested. The appellant testified that he had not committed a fraud. The bankruptcy court ruled that the fraud issue had been litigated to a valid and final judgment at the earlier jury trial and, therefore, the debtor was collaterally estopped from relitigating the fraud issue. For this reason, the bankruptcy court ruled that the judgment against the appellant was nondischargeable under section 523(a)(2)(A).

The debtor contended below that, while the same elements were applied, a lesser standard of proof was used in the initial fraud proceeding than is required to prove fraud under federal

bankruptcy law.<sup>1</sup> Specifically, the creditors were permitted to establish fraud, at the first trial, by the preponderance of the evidence. At a dischargeability proceeding in

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<sup>1</sup> While the standard of proof may differ, a careful examination of state law and the jury instructions used in this case reveals that the elements of fraud for Missouri common law purposes and federal bankruptcy purposes are the same. For the elements of fraud under federal law, see Sweet v. Ritter Fin. Co., 263 F. Supp. 540 (W.D. Va. 1967). Both require a representation that was false and that the person committing the fraud had knowledge of the falsity. In addition, both require that the person asserting fraud materially relied on the representation and that this reliance proximately caused damage. The identical substantive issues were thereby resolved. The other requirements for collateral estoppel are also present. The issue of fraud was actually litigated and was not part of a stipulated, consent or default judgment. The underlying judgment was final and valid. The termination of fraud was essential to that judgment.

bankruptcy, one must establish the elements of fraud, the appellant argues, by clear and convincing evidence. Thus, the appellant argues that he is entitled to a new trial on the issue of fraud.

## II. DISCUSSION

In Brown v. Felsen, 442 U.S. 127, 139-40 (1979), the Supreme Court concluded that the exclusive jurisdiction granted to bankruptcy courts to resolve questions of dischargeability under section 17a(2) of the Bankruptcy Act also prevented the application of claim preclusion -- res judicata -- to resolve questions of dischargeability<sup>4</sup> In footnote 10 of Brown v. Felsen, the

<sup>2</sup> Section 17 of the Bankruptcy Act was replaced by section 523 of the Bankruptcy Code, but the two provisions are substantially the same. Brown v. Felsen, 442 U.S. at 129 n.1.

Supreme Court suggested that issue preclusion -- collateral estoppel -- could still be applied in a later dischargeability proceeding. "If, in the course of adjudicating a state-law question, a state court should determine factual issues using standards identical to those of §17, then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court." Id. at 139 n.10.

### A. Burden of Proof Applied in the Underlying Case

In the underlying case, the federal district court applied Missouri substantive law. In deciding whether the debtor had defrauded his creditors, the court instructed the jury as follows:

In these instructions, you are told that your verdict depends on whether or not you believe certain propositions of fact submitted to you. The burden of causing you to believe a proposition of fact is

upon the party who relies upon that proposition. In determining whether or not you believe any such proposition, you must consider only the evidence and the reasonable inferences derived from the evidence. If the evidence in the case does not cause you to believe a particular proposition submitted, then you cannot return a verdict requiring belief of that proposition.

Upon review of this instruction, along with the other instructions, we conclude that the district court instructed the jury that the burden of proof for fraud is the preponderance of evidence. The appellant did not object to this instruction. The jury returned a verdict finding that Garner had committed fraud. The trial court rejected the appellant's post-trial motions. We affirmed concluding, inter alia, that there was substantial evidence to support a finding of fraud. Grogan v. Garner, 806 F.2d at 836.

## B. Burden of Proof under Section 523(a) of the Bankruptcy Code

The burden of proof for fraud or any of the other exceptions from discharge under section 523(a) of the Bankruptcy Code is far from clear. The Bankruptcy Code is silent as to the burden of proof necessary to establish an exception to discharge under Section 523(a), including the exception for fraud. Both the appellate courts and the bankruptcy courts are split as to whether the standard is clear and convincing evidence or preponderance of the evidence.

There are six circuits that have commented on the burden of proof for fraud under section 523(a).<sup>1</sup> Chrysler Credit Corp. v. Rebhan, 842 F.2d 257, 1262 (11th Cir. 1988); Combs v. Richardson, 838 F.2d 112, 116 (4th Cir. 1988); Matter of Van Horne, 823 F.2d 1285,

1287 (8th Cir. 1987); In re Phillips, 804 F.2d 930, 932 (6th Cir. 1986); In re Black, 787 F.2d 503, 505 (10th Cir. 1986); In re Hunter, 780 F.2d 1577, 1579 (11th Cir. 1986); In re Kimzey, 761 F.2d 421, 423-24 (7th Cir. 1985). Only the Fourth Circuit has adopted the preponderance of the evidence standard. Combs v. Richardson, 838 F.2d 112, 116 (4th Cir. 1988).<sup>3</sup> We, however, have followed the majority rule and applied the clear and convincing standard. Matter of Van Horne, 823 F.2d at 1287.

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<sup>3</sup> Several bankruptcy courts have also applied the more lenient standard. See, e.g., In re Baiata, 12 B.R. 813, 817 (Bkrtcy. E.D. N.Y. 1981); Sweet v. Ritter Finance Co., 263 F.Supp. 540, 543 (W.D. Va. 1967).

The circuits applying the clear and convincing standard have offered various explanations. All the circuits cite to various bankruptcy court decisions applying the clear and convincing standard. Two of the circuits cite to 3 Collier on Bankruptcy, ¶523.08 (15th Ed. 1989) which states without explanation that the appropriate burden of proof is the clear and convincing standard. In re Phillips, 804 F.2d 930, 932 (6th Cir. 1986); In re Black, 787 F.2d 503, 505 (10th Cir. 1986). Two of the circuits state that the clear and convincing standard is necessary to overcome the presumption of innocence. In re Black, 787 F.2d 503, 505 (10th Cir. 1986); In re Hunter, 780 F.2d 1577, 1579 (11th Cir. 1986). Three circuits offer no rationale at all for favoring the more stringent standard. Chrysler Credit

Corp. v. Rebhan, 842 F.2d 1257, 1262 (11th Cir. 1988); In re Phillips, 804 F.2d 930, 932 (6th Cir. 1986); In re Kimzey, 761 F.2d 421, 423-24 (7th Cir. 1985). This Circuit concluded that the stricter standard was appropriate since the general policy of bankruptcy is to provide the debtor with the opportunity for a fresh start and the courts should, thereby, construe provisions of the Bankruptcy Code favoring the debtor broadly. Matter of Van Horne, 823 F.2d at 1287.

We are not persuaded to alter our view of the proper standard of proof for fraud under section 523 of the Bankruptcy Code by the arguments of the Fourth Circuit. The Fourth Circuit reasoned, in concluding that all the exceptions to discharge contained in section 523 of the Code are governed by the preponderance of the evidence stan-

dard, that the balance of the "fresh start" policy and the policies implicitly announced by Congress when it created the exceptions to discharge does not require a heightened standard of proof. Combs v. Richardson, 838 F.2d 112, 116 (4th Cir. 1988). We are not convinced. While the legislative history is scant on this issue, we feel that it is fair to presume that Congress was aware that the prevailing view at the time of adoption was that fraud, for both section 523 and state common law purposes, had to be proved by clear and convincing evidence. In addition, the Fourth Circuit's manner of interpretation effectively reads the "fresh start" policy out of any provision of the Code, provided that provision could be interpreted as conflicting with the "fresh start" policy. We do not believe that principles of

statutory interpretation dictate such a reading where Congress has not expressly announced a contrary result. Therefore, we continue to follow the standard set forth in Matter of Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987).

Finally, we cannot agree with the bankruptcy court and the district court that the preponderance of the evidence standard and the clear and convincing standard are the same in this context. The Supreme Court has in a recent series of cases stated that the two standards are in function and in practice different. See Price Waterhouse v. Hopkins, 109 S. Ct. 775 (1989) and cases cited therein. In this instance, the higher standard protects the "fresh start" policy. Accordingly, the decisions of the bankruptcy court and the district court are reversed.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS,  
EIGHTH CIRCUIT

IN THE UNITED STATES DISTRICT  
COURT FOR THE  
WESTERN DISTRICT OF MISSOURI  
WESTERN DIVISION

JOHN R. HENSON AND )  
COY R. GROGAN, )  
 )  
Plaintiffs, )  
 )  
v. ) No. 87-0434-CV-W- 1  
 )  
FRANK J. GARNER, Jr. )  
 )  
Defendant )

ORDER

This is an appeal by the debtor,  
Frank J. Garner, Jr., from the  
Bankruptcy Court's decision that the  
judgment obtained against him by appel-  
lees John H. Henson and Coy R. Grogan  
should not be dischargeable in his  
bankruptcy proceeding.

The damage case was originally tried  
before a jury in the United States Dis-  
trict Court for the Western District of  
Missouri. The jury found that appellant  
Frank J. Garner had committed common  
law fraud; breach of fiduciary duty.

owed to appellees John H. Henson and  
Coy R. Grogan; and that he violated Sec-  
tion 10(b) of the Securities and  
Exchange Act of 1934. The jury awarded  
appellees actual damages on all three  
counts and punitive damages on the  
fraud count. The jury's judgment and  
award was affirmed by the United States  
Circuit Court of Appeals for the Eighth  
Circuit at 806 F.2d 829.

The Bankruptcy Court, after hearing  
the evidence presented on the issue of  
dischargeability of the judgment, found  
that the fraud issue had been litigated  
in the U.S. District Court and that the  
debtor should be collaterally estopped  
from relitigating the issues behind the  
judgment obtained by appellees in the  
U.S. District Court.

On October 21, 1985, the appellant  
filed his petition for relief under

Chapter 11 of the Bankruptcy Code and listed the judgment obtained against him by appellees, as a dischargeable debt under the Bankruptcy Code.

On May 7, 1986, in appellees filed their complaint for determination that their judgment debt was non-dischargeable pursuant to 11 U.S.C. § 523(a)(2). Trial on the dischargeability issue was held on January 6, 1987, at which time the appellees introduced no testimony but did offer four exhibits, to-wit: (1) a copy of appellees' first amended petition (Exhibit #1); (2) a copy of the addendum to appellant's brief filed with the Eighth Circuit Court containing instructions to the jury, and the verdict directors as well as the jury verdict and the district court's judgment (Exhibit #2); (3) the opinion of the Eighth Circuit Court of Appeals affirming the appellee's judgment against

appellant (Exhibit #3); and (4) a letter from the Eighth Circuit transmitting the opinion (Exhibit #4).

Appellant then presented evidence by his testimony, denying any wrongdoing whatsoever.

After the filing of post-trial briefs, the Bankruptcy Court by way of a memorandum opinion and order, ruled that the identical issues had been tried in the U.S. District Court jury trial that the Bankruptcy Court tried, and that collateral estoppel should apply, thus making appellees' district court judgment against appellant non-dischargeable under § 523(a)(2)(A).

The Bankruptcy Court in its opinion found for the purposes of determining the dischargeability of a debt under § 523, there is no real distinction between the "preponderance of the

evidence" and "clear and convincing evidence" burden of proof standards.

Appellees appeal this ruling of the Bankruptcy Court.

The issue raised by the appellant on appeal and to be taken up by this court is whether or not the burden of proof to prove common law fraud and the burden of proof standard required to be utilized by the Bankruptcy Court in a dischargeability suit are the same standard or are they sufficiently different as to require a bankruptcy court to re-litigate the issues tried before the District Court jury.

#### Standard of Appellate Review

The findings of fact made by the Bankruptcy Court are not to be set aside unless they are clearly erroneous. Bankruptcy Rule 8013. The Bankruptcy Court's conclusions of law

are to be given de novo review. In re Newcomb, 744 F2d 621, 625 (8th Cir.1985).

#### Findings

The Bankruptcy Court, in its amended memorandum opinion and order found that the identical factual issues tried and decided by a unanimous jury in the district court case were the same facts required to be determined by the Bankruptcy Code to determine if a debt had been obtained by fraud and thus not dischargeable.

The Bankruptcy Court then determined that the issues had been fully litigated and properly decided using identical standards, and collateral estoppel applied to bar relitigation of those issues in the Bankruptcy Court, as stated in Brown v. Felsen, 442 U.S.

127, 60 L.Ed.2d 767, 99 S.Ct. 2205  
(1979).

The Bankruptcy Court in its memorandum makes reference to the discussion in footnote 6 by Judge Stewart of the In re: Curl case, analyzing how the apparent conflict as to the two standards of the burden of proof have arisen. In re Curl, 49 B.R. 302 (Bankr. W.D. Mo. 1985). This court agrees with the memorandum and finding of the Bankruptcy Court that for purposes of litigation under § 523 of the Bankruptcy Court to determine dischargeability of debts, there is no difference in the standard to apply.

This court will therefore affirm the finds of the Bankruptcy Court in regard to that issue.

This court will further affirm the judgment by finding that the standard of proof becomes more of an exercise in semantics for the courts and has no distinguishable feature that can be pointed out to a jury as to how a factual issue is to be decided by them.

Appellant argues that the burden of proof used in the underlying jury trial before the U.S. District Court is the common law burden of proof of the "preponderance of the evidence."

This court, in reviewing the Bankruptcy Court file, notes that Exhibit 2 introduced by appellants, does not have Missouri Approved Instruction 3.01 (burden of proof instruction) as a part of the exhibit and this court must therefore assume as indicated in the briefs of the appellant, that the standard MAI 3.01 burden of proof instruction was used, to-wit:

### 3.01 [1981 Revision]

#### Burden of Proof--General

In these instructions, you are told that your verdict depends on whether or not you believe certain propositions of fact submitted to you. The burden of causing you to believe a proposition of fact is upon the party whose claim [or defense] depends upon that proposition. In determining whether or not you believe any such proposition, you must consider only the evidence and the reasonable inferences derived from the evidence. If the evidence in the case does not cause you to believe a particular proposition submitted, then you cannot return a verdict requiring belief of that proposition.

Obviously the words "preponderance of the evidence" are not used anywhere in this instruction.

To understand the intent and purpose of the MAI 3.01 Burden of Proof instruction, it is necessary to read the 1963 Report to the Missouri Supreme Court at page xxxvii in the MAI Approved Instructions, 3rd Edition. A reading of that report advises the reader that the intent of the burden of proof instruction is to simply and accurately tell the

jury what is meant by burden of proof and to use such terms as "preponderance," or "greater weight" in an instruction without some further explanation, could be understood by a jury as requiring proof which removes all doubt. It goes on to say, "after studying decisions of nearly every court in the country, we concluded that attempts to explain universally adds to the confusion." It is obvious from a reading of this report that the M.A.I. drafting committee ran into the same problem that is facing this court today and has faced courts throughout the land. It appears that the Committee's intent was to try to resolve this semantic jungle by merely attempting in as simple language as possible to tell the jury the person seeking to recover must prove the proposition of fact on which the party relies. Thus it appears to

this court that the general burden of proof instructions should not be categorized or placed in either category requiring a "preponderance of the evidence" or requiring "clear and convincing evidence", but merely requiring the parties seeking recovery in a jury trial to put forth evidence to convince the triers of the fact that they are entitled to recovery.

In making these findings, the court is mindful of the fact that there are MAI burden of proof instructions for specific types of cases in which the instructions use the language "clear and convincing." The use of these burden of proof instructions arose from court decision or statutory requirements, to-wit: (1) in cases whether there is a question as to whether or not a gift was given to a person by a decedent because that stan-

dard was set by the Missouri Supreme Court in the case of In re Passman's Estate, 537 S.W.2d 380 (MAI 3.04); (2) in libel and slander cases in which Missouri recognized the actual malice standard set forth by the United States Supreme Court case New York Times Company v. Sullivan, 376 U.S. 254, 84 S.Ct. 710, 11 L.Ed.2d 686 (1964) (MAI 3.05); and (3) to determine if an individual should be committed because of mental disease or defect as required by statute, § 632.475, RSMo 1986.

The keystone of our legal system is to give litigants a full opportunity to present their side of the litigation and allow a court or jury to reach a decision, and then abide by that decision.

This has been done in this case. Appellant's trial in the U.S. District Court used Missouri Civil Instructions. Both sides were permitted to try their case in full, the jury was instructed to render a verdict based upon the facts and the law given in the court's instructions. A re-litigation of this case in Bankruptcy Court on the identical fact issues would be to permit the party who loses at a jury trial to have a second day in court on the same issue he and his opponent were fully heard previously. If permitted, all like cases would result in duplicitous litigation resulting in an unreasonable burden on the bankruptcy court.

The court therefore adopts the findings of the Bankruptcy Court and incorporates them in these findings by reference, and affirms the decision of the Bankruptcy Court.

IT IS SO ORDERED.

(/s/ Dean Whipple )  
Dean Whipple  
U.S. District Judge

DATED: February 29, 1988.

IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE WESTERN DISTRICT OF MISSOURI

In Re: )  
 )  
Frank J. Garner, ) Case No. 85-0375-52  
Jr. )  
Debtor )  
 )  
John R. Henson & )  
Coy R. Grogan, )  
 )  
Plaintiffs, )  
 )  
v. ) Adv. No. 83-183-2  
 )  
Frank J. Garner, )  
Jr., )  
 )  
Defendant. )

MEMORANDUM OPINION AND ORDER

This adversary action by two creditors seeking to avoid discharge of debtor on their respective claims came to an abrupt halt at the conclusion of creditors' case when debtor elected to present no evidence and stood on his oral Motion for Dismissal made when the plaintiff/creditors rested. Creditors had each obtained a jury verdict against debtor in the United States District Court for the Western District of

Missouri, before the petition for reorganization was filed. Debtor had appealed the resulting judgments to the Eighth Circuit Court of Appeals. That latter tribunal affirmed the judgments post petition and this Section 523 adversary proceeding, having been timely filed, proceeded to trial. Creditors did not offer the transcript of the proceedings in the District Court case. Instead, they introduced only four exhibits and rested.

Those four exhibits were:

- Exhibit 1: A copy of creditors' first amended complaint.
- Exhibit 2: A copy of debtor's addendum to the brief of debtor to the Eighth Circuit, containing instructions to the jury and the Verdict Direc-

tor as well as the jury verdict and the District Court judgment.

Exhibit 3: The opinion of the Eighth Circuit Court of Appeals.

Exhibit 4: Letter from Eighth Circuit Court of Appeals transmitting the opinion.

The Court, therefore, is required to determine from the exhibits if creditors have made a case and established all elements necessary under Section 523.

The original District Court complaint is drawn in five counts. Count I alleged a common law fraud, potentially cognizable under Section 523(a)(2). Count II alleged a breach of fiduciary duty, potentially cognizable under Section 523(a)(4). Count III alleged a use of interstate instrumentality to make alleged misrepresentations. This

Count adds nothing in a bankruptcy proceeding under Section 523. Count IV alleged a RICO violation which again, adds nothing to a bankruptcy proceeding under Section 523. For the reasons stated hereafter, the Court will to consider only Count I or the common law fraud Count.

The jury instructions in Count I required the jury to find in Instruction Number 6 and Instruction Number 23 (respectively to each creditor):

First: That debtor made a representation to each creditor.

Second: That the representation was false.

Third: That the representation was material in causing each creditor's decision.

Fifth: That each creditor relied on the debtor's representation.

Sixth: That as a direct result of such representation each creditor was damaged.

Seventh: That each creditor did not discover the alleged fraud until a later date.

The jury verdict was unanimous in favor of each creditor and against the debtor on Count I, as well as two other counts. After the filing of post trial motions, the District Court ruled:

"Here there clearly was sufficient evidence to support the jury's conclusion that defendant...intentionally defrauded plaintiffs."

The United States Court of Appeals for the Eighth Circuit unanimously affirmed and held that there was sufficient evidence to support the verdict.

Since 1970, the bankruptcy courts have been the sole arbiter of what debts are not discharged by a bankruptcy proceeding. Brown v.

Felsen, 442 U.S. 127, 99 S.Ct. 2205

(1979) tells us that: "... are the type of questions that Congress intended the bankruptcy court would resolve," (1.c. 2112). Although that opinion dealt only with a state court judgment, there is no reason to suspect that the same rule would not apply to judgments rendered in Federal Courts also. The question then becomes did the judgment in the District Court constitute so similar a finding of fraud in that action as to provide a basis for the bankruptcy court to determine that Section 523 fraud was committed thereby rendering the judgment nondischargeable, or is the debtor collaterally estopped from relitigating those issues of fact determined by a prior finding thereon. Again Brown v. Felsen Id. footnote 10, page 2213, supplies the answer. "If in the course of

adjudicating a state-law question, a state court should determine factual issues using standards identical to those of Section 17, then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court." Thus, the Court is led to the conclusion that the elements to be proved under Section 523(a)(2) must be compared with the elements decided by the unanimous jury in the District Court case, and, if identical, as to content and standard, creditors have borne their burden.

Under Section 523(a)(2) those elements are:

- (1) Utterance or issuance of a representation,
- (2) Proof of the falsity of the representation,

- (3) Proof of knowledge on the part of the maker of that falsity,
- (4) Intent to mislead or deceive the alleged victim by the maker,
- (5) Reliance on the representation by the victim,
- (6) Proof that damage occurred to the alleged victim.

(See Sweet v. Ritter Finance Company, 263 F. Supp. 540 (W.D. Va. 1967)).

By comparing these standards with instructions Number 6 and Number 23, it appears to the Court that very element required to be found by the Court in the dischargeability hearing was already found by the jury in the District Court verdict. Further those findings received the judicial seal of approval from the District Court in its Order of August 7, 1986, when it stated: "Here, there clearly was suffi-

cient evidence to support the jury's conclusion that defendant violated his fiduciary duty and intentionally defrauded plaintiffs." The Court of Appeals, Eighth Circuit, stated: "We find substantial evidence, as did the jury, to support proof of fraud committed by Garner against the plaintiffs."

Therefore, although this Court believes and holds that the Bankruptcy Court is the sole arbiter of Section 523 dischargeability vel non, nevertheless where identical factual issues have been fully litigated and properly decided using identical standards by courts of appropriate jurisdiction, collateral estoppel bars relitigation of those issues in this Court. This leads to the final question to be determined by this Court, i.e., were identical standards used?

In defendant's brief, the point is made that the standard in the District Court trial was "preponderance of the evidence" while the standard should be "clear and convincing" and that the two are totally dissimilar. If defendant's point is well taken, then obviously collateral estoppel does not come into play and there is insufficient evidence before the Court to determine dischargeability. The Honorable Dennis J. Stewart, Chief Bankruptcy Judge of this District, had occasion to explore this identical question in a footnote to his opinion in Matter of Curl, 49 B.R. 302 (Bkr. W.D. Mo. 1985), see footnote 6. This Court, although not bound by that ruling, frankly considers it not only the best exposition of how the apparent divergence arose, but strongly recommends that any counsel engaged in Section 523 litigation regard that

opinion (and the footnotes) as required reading for a thorough understanding of the elements of proof and the applicability of evidentiary standards. Accordingly, this Court concludes that there is no real distinction between "preponderance of the evidence" and "clear and convincing" as regards Section 523 litigation.

Inexorably then, the Court concludes that through collateral estoppel, creditors sustained the burden of proof and through their exhibits sustained the burden as to all elements of dischargeability. The judgment rendered on common law fraud which was pled in Count I of plaintiff's original complaint in Federal District Court is, therefore, ruled to be nondischargeable. No ruling is necessary on any other Count, even Count II, the alleged fiduciary breach, inasmuch

as only one recovery may be had by creditors. Although this result is in favor of creditors, the Court must point out that it believes better practice would be to introduce the transcript in such a proceeding, and that creditors in similar proceedings run a substantial risk of not presenting the Court with sufficient evidence upon which to base a ruling when they rely upon collateral estoppel alone.

SO ORDERED this 24th day of February, 1987.

(/s/ Frank Koger )  
Bankruptcy Judge

UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

NO. 88-1991WM

In Re: Frank J. Garner, Jr. \*

Debtor. \*

John R. Henson and \*

Coy R. Grogan, \*

Appellees, \*

v. \*

Frank J. Garner, Jr., \*

Appellant. \*

Appeal from the United States District  
Court for the Western District of Mis-  
souri

Appellees' petition for rehearing has  
been considered by the court and is  
denied.

September 12, 1989

Order Entered at the Direction of the  
Court:

(/s/ Robert D. St. Vrain)

Clerk, U.S. Court of Appeals, Eighth  
Circuit

SECTION 523. (11 U.S.C. § 523)

§ 523. Exceptions to discharge.

(a) A discharge under section 727,  
1141, 1228(a), 1228(b), or 1328(b) of  
this title does not discharge an  
individual debtor from any debt--

(1) for a tax or a customs duty--

(A) of the kind and for the  
periods specified in section  
507(a)(2) or 507(a)(7) of this  
title, whether or not a claim for  
such tax was filed or allowed;

(B) with respect to which a  
return, if required--

(i) was not filed; or

(ii) was filed after the  
date on which such return was  
last due, under applicable law  
or under any extension, and

after two years before the date  
of the filing of the petition;  
or

(C) with respect to which the  
debtor made a fraudulent return or  
willfully attempted in any manner  
to evade or defeat such tax;

(2) for money, property, services,  
or an extension, renewal or refinanc-  
ing of credit, to the extent obtained  
by--

(A) false pretenses, a false  
representation, or actual fraud,  
other than a statement respecting  
the debtor's or an insider's finan-  
cial condition;

(B) use of a statement in writ-  
ing--

(i) that is materially  
false;

(ii) respecting the debtor's  
or an insider's financial condi-  
tion;

(iii) on which the creditor  
to whom the debtor is liable  
for such money, property, ser-  
vices, or credit reasonably  
relied; and

(iv) that the debtor caused  
to be made or published with  
intent to deceive; or

(C) for purposes of  
subparagraph (A) of this  
paragraph, consumer debts owed to  
a single creditor and aggregating  
more than \$500 for "luxury goods  
or services" incurred by an  
individual debtor on or within  
forty days before the order for  
relief under this title, or cash  
advances aggregating more than  
\$1,000 that are extensions of con-

sumer credit under an open end credit plan obtained by an individual debtor on or within twenty days before the order for relief under this title, are presumed to be nondischargeable: "luxury goods or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act (15 U.S.C.1601 et seq.);

(3) neither listed nor scheduled under section 521(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit--

(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(5) to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement, but not to the extent that--

--

(A) such debt is assigned to another entity, voluntarily, by operation of law, or otherwise (other than debts assigned pursuant to section 402(a)(26) of the Social Security Act, or any such debt which has been assigned to the Federal Government or to a State or any political subdivision of such State); or

(B) such debt includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance, or support;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty--

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

(8) for an educational loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or a non-profit institution, unless--

(A) such loan first became due before five years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition; or

(B) excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents;

(9) to any entity, to the extent that such debt arises from a judgment or consent decree entered in a court of record against the debtor wherein liability was incurred by such debtor as a result of the debtor's operation of a motor vehicle while legally intoxicated under the laws or regulations of any jurisdiction within the United States or its territories wherein such motor vehicle was operated and within which such liability was incurred; or

(10) that was or could have been listed or scheduled by the debtor in a prior case concerning the debtor under this title or under the Bankruptcy Act in which the debtor waived discharge, or was denied a discharge under section 727(a)(2), (3),

(4), (5), (6), or (7) of this title, or under section 14c(1), (2), (3), (4), (6), or (7) of such Act.

(b) Notwithstanding subsection (a) of this section, a debt that was excepted from discharge under subsection (a)(1), (a)(3), or (a)(8) of this section, under section 17a(1), 17a(3), or 17a(5) of the Bankruptcy Act, under section 439A of the Higher Education Act of 1965 (20 U.S.C. 1087-3), or under section 733(g) of the Public Health Service Act (42 U.S.C. 294f) in a prior case concerning the debtor under this title, or under the Bankruptcy Act, is dischargeable in a case under this title unless, by the terms of subsection (a) of this section, such debt is not dischargeable in the case under this title.

(c) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

(d) If a creditor requests a determination of dischargeability of a consumer debt under section (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except

that the court shall not award such costs and fees if special circumstances would make the award unjust.

APR 4 1990

JOSEPH F. SARNIOL, JR.  
CLERK

(2)  
No. 89-1149

**In the Supreme Court of the United States**

**OCTOBER TERM, 1989**

**COY R. GROGAN and  
JOHN H. HENSON,**  
*Petitioners,*

**vs.**

**FRANK J. GARNER, JR.,**  
*Respondent.*

**PETITION FOR WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT**

**RESPONDENT'S BRIEF IN OPPOSITION**

**JOHN BENSON WILLIAMS**  
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**Counsel of Record**

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*Counsel for Respondent*

**No. 89-1149**

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---

**In the Supreme Court of the United States**  
**OCTOBER TERM, 1989**

---

**COY R. GROGAN and**  
**JOHN H. HENSON,**  
*Petitioners,*

**vs.**

**FRANK J. GARNER, JR.,**  
*Respondent.*

---

**PETITION FOR WRIT OF CERTIORARI TO**  
**THE UNITED STATES COURT OF APPEALS**  
**FOR THE EIGHTH CIRCUIT**

---

**RESPONDENT'S BRIEF IN OPPOSITION**

---

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## **RESPONDENT'S BRIEF IN OPPOSITION**

The Respondent, Frank J. Garner, Jr., respectfully requests that this Court deny the Petition for Writ of Certiorari, seeking review of the Eighth Circuit's opinion in this case. That opinion is reported at 881 F.2d 579.

### **REASON WHY THE PETITION SHOULD BE DENIED**

1. There is no conflict in the decision of the Courts of Appeals.

Both the Eighth Circuit opinion in this case and the Petition for Writ of Certiorari conclusively demonstrate that the Eighth Circuit is following what it terms the majority rule followed by five of the circuits in requiring a clear and convincing standard of proof for fraud under Section 523(a) of the Bankruptcy Code.

However, the alleged conflicting decision of the Fourth Circuit, Combs v. Richardson, 838 F.2d 112 (4th Cir. 1988), can and should be distinguished on its facts, in that it: (1) dealt with a willful and malicious injury under Section 523(a)6 rather than a fraud under Section 523(a)2; and, (2) the Court of Appeals in Combs was satisfied with the review by the Bankruptcy Court and the Court of Appeals in the case at bar was not.

**CONCLUSION**

Accordingly, inasmuch as the Court of Appeals has followed the standard accepted by five circuits, and the decision of the Court of Appeals for the Fourth Circuit can be distinguished on its facts, this Court should decline to grant certiorari.

Respectfully submitted,

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④

No. 89-1149

Supreme Court, U.S.  
FILED

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JOSEPH F. SPANIOLO, JR.  
CLERK

In The  
**Supreme Court of the United States**  
October Term, 1989

COY R. GROGAN AND JOHN H. HENSON,  
*Petitioners,*  
v.

FRANK J. GARNER, JR.,  
*Respondent.*

On Writ Of Certiorari To The United States  
Court Of Appeals For The  
Eighth Circuit

**JOINT APPENDIX**

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**Petition For Certiorari Filed  
December 11, 1989  
Certiorari Granted April 30, 1990**

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CHRONOLOGICAL LIST OF  
RELEVANT DOCKET ENTRIES

May 7, 1986 -	Complaint Under Section 523(a) filed in Bankruptcy Court for the Western District of Missouri.
May 15, 1986 -	Answer filed by Debtor Frank J. Garner, Jr. in Bankruptcy Court for the Western District of Missouri.
January 6, 1987 -	Adversary Hearing before the Honorable Frank Koger United States Bankruptcy Judge.
February 24, 1987 -	Memorandum Opinion and Order entered by Bankruptcy Judge Koger holding Garner's debt to Grogan and Henson is non-dischargeable under § 523(a).
March 20, 1987 -	Order Denying Motion To Alter Or Amend Judgment entered.
April 9, 1987 -	Designation of Issue on Appeal by Debtor Garner for U.S. District Court.
May 11, 1987 -	Notice of designation of record on appeal entered by U.S. District Court.
June 17, 1987 -	Amended Memorandum Opinion and Order entered by Bankruptcy Judge Koger.
February 29, 1988 -	Order and Judgment entered by U.S. District Judge Whipple affirming Bankruptcy Court decision.
May 19, 1988 -	Order entered by Judge Whipple denying appellant's motion to alter or amend judgment.
June 17, 1988 -	Notice of Appeal filed by Debtor Garner.

July 7, 1988 - Appeal Briefing Schedule Order issued by Eighth Circuit Court of Appeals.

August 9, 1989 - Judgment entered by the Eighth Circuit Court of Appeals reversing the decision of the U.S. District Court.

September 12, 1989 - Motion for rehearing denied by the Eighth Circuit Court of Appeals.

December 11, 1989 - The Petition for a Writ of Certiorari filed.

April 30, 1990 - The Petition for a Writ of Certiorari granted.

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UNITED STATES BANKRUPTCY COURT FOR THE  
WESTERN DISTRICT OF MISSOURI

In Re:	)	
Frank J. Garner, Jr.,	)	
	)	
	)	No.
Debtor,	)	85-03755-2-11
	)	
John H. Henson and	)	Adversary No.
Coy R. Grogan,	)	86-0183-2-11
	)	
Plaintiffs,	)	
	)	
v.	)	
	)	
Franklin J. Garner, Jr.,	)	
	)	
Defendant.	)	

COMPLAINT UNDER SECTION 523(a)

(Filed May 7, 1986)

For their complaint against the defendant, Franklin J. Garner, Jr. ("Garner"), John H. Henson ("Henson") and Coy R. Grogan ("Grogan"), the plaintiffs, state the following:

1. This Court has jurisdiction over this proceeding under 28 U.S.C. § 157(b)(2)(I).
2. Garner is the debtor in *In re Garner*, No. 85-03755-2-11, a case filed under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of Missouri.
3. Henson and Grogan are creditors of Garner.
4. This is an adversary proceeding to determine the dischargeability of debts owed by Garner to Henson and Grogan.

5. Prior to 21 October 1985, the date Garner filed his bankruptcy petition, Garner owed Henson for \$409,158.00, plus interest from 8 May 1985 at the rate set by 28 U.S.C. § 1961. That debt was based on a judgment in favor of Henson and against Garner entered in a civil action in the United States District Court for the Western District of Missouri in a matter styled *Grogan and Henson v. Garner*, No. 84-0516-CV-W-5. The basis for the judgment was that Garner obtained for his own use, and through a willful and malicious act of fraud and conversion, the proceeds from the sale of stock in a corporation in which Henson was a shareholder.

6. Garner's debt to Henson is nondischargeable under § 523(a)(2) and § 523(a)(6) of the Bankruptcy Code.

7. Garner's debt to Grogan is nondischargeable under § 523(a)(2) and § 523(a)(6) of the Bankruptcy Code.

WHEREFORE, John H. Henson and Coy R. Grogan each request that this Court determine the debts of Franklin J. Garner, Jr. to them are nondischargeable, and that the plaintiffs have such other and further relief as is just.

(Signatures And Certificate Of Service  
Omitted In Printing)

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IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE WESTERN DISTRICT OF MISSOURI  
WESTERN DIVISION

ADVERSARY NO. 86-0183-2-11

(Caption Omitted In Printing)

ANSWER

(Filed May 15, 1986)

COMES NOW Defendant, Franklin J. Garner, Jr., and for his Answer to Plaintiffs' Complaint herein, admits, denies and states as follows:

1. Defendant admits the allegations set forth in paragraph 1 of Plaintiffs' Complaint.

2. Defendant admits the allegations set forth in paragraph 2 of Plaintiffs' Complaint.

3. Defendant admits that Plaintiffs are currently creditors pursuant to a judgment entered by the United States District Court for the Western District of Missouri, and further states that said judgment is now on appeal in the United States Court of Appeals for the Eighth Circuit in response to paragraph 3 of Plaintiffs' Complaint.

4. Defendant admits the allegations set forth in paragraph 4 of Plaintiffs' Complaint.

5. In response to paragraph 5 of Plaintiffs' Complaint, Defendant admits the judgment of the United States District Court for the Western District of Missouri, denies all other allegations set forth in paragraph 5 of Plaintiffs' Complaint and further states to the Court that the judgment entry of the United States District Court for the Western District of Missouri speaks for itself.

6. Defendant denies the allegations set forth in paragraph 6 of Plaintiffs' Complaint.

7. Defendant denies the allegations set forth in paragraph 7 of Plaintiffs' Complaint.

8. That as previously stated, the judgment entered in favor of Plaintiffs against Defendant in the United States District Court for the Western District of Missouri is now pending on appeal in the United States Court of Appeals for the Eighth Circuit. That the oral argument on said appeal is scheduled in the very near future with a subsequent ruling on the appeal anticipated thereafter. Defendant respectfully requests that this Court take no action on Plaintiffs' Complaint herein until the decision of the United States Court of Appeals for the Eighth Circuit is rendered. In the event that Defendant is successful in his appeal to the Eighth Circuit, Plaintiffs' Complaint herein would be rendered moot and that any action by this Court on Plaintiffs' Complaint herein would be subject to the decision of the appeal pending before the Eighth Circuit.

9. Defendant affirmatively states that Plaintiffs' Complaint herein fails to state a cause of action upon which relief may be granted.

WHEREFORE, having fully answered Plaintiffs' Complaint herein, Defendant Franklin J. Garner, Jr. requests that Plaintiffs take naught by their Complaint, that any indebtedness that may be due and owing from Defendant to Plaintiffs be deemed dischargeable, and that Defendant have such other and further relief as the Court deems just and proper in the premises.

(Signatures And Certificate Of Service  
Omitted In Printing)

No. 86-0183-2-11

(Caption Omitted in Printing)

TRANSCRIPT OF ADVERSARY HEARING  
BEFORE THE HONORABLE FRANK KOGER  
UNITED STATES BANKRUPTCY JUDGE

(Filed May 5, 1987)

(p. 2) COURT IN SESSION AT 2:10 P.M.

THE COURT: John R. Henson, Coy R. Grogan, plaintiffs, versus Frank J. Garner, Jr., adversary on dischargeability.

Attorney for the plaintiff is -

MR. FRANKLIN: Thomas M. Franklin.

THE COURT: Okay. You may proceed, Mr. Franklin.

MR. FRANKLIN: We have not discussed the foundation law aspects of this, do you have any objections to identification or to the genuineness of this document?

MR. BARKER: I've got no foundation objections to it, no.

MR. FRANKLIN: Your Honor, at this time we offer Exhibit #1 for the plaintiffs, which is the First Amended Complaint in a civil action in the United States District Court for the Western District of Missouri, styled Coy R. Grogan and John H. Henson versus Frank J. Garner, Jr. And Exhibit #1 consists of the First Amended Complaint in that civil action.

MR. BARKER: Your Honor, defendant would object to it on the grounds of relevancy. The plaintiff has

plead a judgement in his pleading. We have admitted to that in our responsive pleading and I don't believe that the complaint in the underlying transaction has any relation to the claim of dischargability here. We would object to it on that basis.

THE COURT: Well, I think it forms part of the Court file and the Bankruptcy Court is an adjunct or branch of the (p. 3) District Court and therefore I suspect that I can take judicial notice and I am going to admit it.

MR. FRANKLIN: Your Honor, at this time, plaintiffs offer Plaintiff's Exhibit #2, which consists of an Addendum to the Brief of the Appellant filed by Frank J. Garner, Jr. in the United States Court of Appeals for the 8th Circuit, case number 85-2098-WM, styled Coy R. Grogan and John H. Henson, appellees, versus Frank J. Garner, Jr., appellant. This document, which I understand Mr. Barker is also waiving identification and genuineness objections, consists of the jury instructions given in the matter that was heard in civil action, consists also of the verdict directive forms and also the judgement entered by the District Court in the civil action filed in the United States District Court for the Western District of Missouri. Plaintiff is offering Defendant's [sic] Exhibit #2 at this time.

MR. BARKER: Your Honor, we would again object to everything except the judgement that's contained in Plaintiff's #2 on this same basis and maybe to shorten this up, Mr. Franklin and I agreed to certain documents arising out of the underlying trial, as far as foundation and those type of objections - we will waive those. I will simply have a standing relevancy objection

to all of those documents and it would be my understanding that the Court would overrule that objection.

(p. 4) THE COURT: Well, the brief, I'm not so sure - that's in the Court of Appeals?

MR. BARKER: Yes.

MR. FRANKLIN: It is an addendum, Your Honor

THE COURT: Oh, it's an addendum.

MR. FRANKLIN: - that was submitted -

THE COURT: It's not the brief.

MR. FRANKLIN: It contains copies of the jury instructions used in the District Court, a copy of the District Court's judgement and a copy of the verdict directing forms. We're offering that as relevant because, although as Mr. Barker indicates, the debtor has admitted the judgment in the District Court, they are denying certain features of the complaint of non-dischargability here at issue. We're alleging that the debtor is barred by the doctrine of collateral estoppel from relitigating all of the fact issues that were decided in the District Court. The instructions clearly specify all of the fact issues that were decided in the District Court.

THE COURT: All right. I'm going to admit that document.

MR. FRANKLIN: Your Honor, at this time the plaintiffs offer Plaintiff's Exhibit #3, which is an opinion of the United States Court of Appeals for the 8th Circuit in case number 85-2098, Coy R. Grogan and John H. Henson versus Frank J. Garner, Jr.

(p. 5) MR. BARKER: Your Honor, we'd made the same objection to that document.

THE COURT: It will be admitted.

MR. FRANKLIN: And finally, Your Honor, plaintiffs offer Plaintiff's Exhibit #4, a letter from the clerk to the United States Court of Appeals dated December the 8th, 1986.

MR. BARKER: Same objection.

THE COURT: Who's the letter from?

MR. FRANKLIN: The letter is from a deputy clerk, Your Honor, and the letter is offered to indicate that a judgement was entered by the 8th Circuit.

THE COURT: It will be admitted.

MR. FRANKLIN: Your Honor, the plaintiffs rest.

THE COURT: All right. Mr. Barker?

MR. BARKER: Your Honor, the defendant would move for a directed verdict at this time on the basis that there has been no showing that the - according to Section 523A2A that the underlying debt is based on the false pretense, false representation or actual fraud. I think the other ground that has been pled is under Section 6 for wilful and malicious injury by the debtor to another entity or the property of another entity. I don't think there has been any showing of that. I'm not aware of any case - any bankruptcy case in this country that has held that simply a showing of a judgement in an underlying case is sufficient to authorize the Court to (p. 6) exempt a debt from discharge. The debt that is reflected in the

judgement of the District Court - it is simply not sufficient to do tht [sic]. I think that the Court is not required to wade through a bunch of documents to determine whether or not this debt is discharable [sic] or not. I think the burden's on the plaintiff to produce affirmative evidence that either a false statement or a false misrepresentation was made, the extent of the injury that was done thereby and that simply hasn't been done. All they've done is say, "Hey, we've got a judgement that is based on fraud and so therefore it ought not to be dischargable." The position that this puts us in is to either A, attempt to impeach the judgement, which I'm not sure that we can do or that anyone can do and it gives us nothing to fight with. There are a lot of errors that were claimed in that trial. The case has gone to the 8th Circuit. The 8th Circuit ruled about a month ago and there are still other remedies that the debtor has in the appellate system with respect to that case. It's by no means over and for the plaintiffs to rely on this collateral estoppel theory without producing any - either one of them, either Mr. Grogan or Mr. Henson, to get up here and say, "Well, Frank Garner did this to me and it cost me this much money." I don't believe that it is sufficient to get up here and do this. I would ask the Court to direct a verdict in favor of the debtor and against the plaintiffs.

THE COURT: I'm going to have look [sic] at the exhibits at (p. 7) this point. Mr. Barker, I think you have an excellent point. I don't think frankly that I have enough here to make any ruling because the normal rule is that it is the Bankruptcy Court that must make the determination of non-dischargability or dischargability. However, there are certainly allegations of fraud in here

and there are jury findings, etc. Although, as I say, I think you have an excellent point, for the moment I am going to overrule your motion and you may present any evidence you wish or not and I will go on from there.

MR. BARKER: Your Honor, may we have about five minutes?

THE COURT: Sure.

MR. BARKER: I had anticipated live witnesses from the plaintiff's side and I really hadn't prepared - and I would like to discuss just for a few moments with my client.

THE COURT: Certainly. The Court will recess for 10 minutes.

COURT IN RECESS FROM 2:22 P.M. TO 2:35 P.M.

THE COURT: All right, Mr. Barker.

MR. BARKER: At this time we would call Frank Garner.

FRANK J. GARNER, JR., DEFENDANT, SWORN

#### DIRECT EXAMINATION

BY MR. BARKER:

Q. Would you state your name for His Honor, please?

A. Frank J. Garner, Jr.

(p. 8) Q. You are the debtor in this Chapter 11 filing?

A. Yes, sir.

Q. And the defendant in this adversary action?

A. Yes.

Q. Mr. Garner, did you at any time during 1978 make any false statements of existing fact to Mr. Coy Grogan?

MR. FRANKLIN: I'm sorry. Are you done?

MR. BARKER: That's my question.

MR. FRANKLIN: I'd like to make an objection on the grounds of relevancy because this fact issue has been fully litigated previously. A judgement has been entered against the debtor on this issue and I believe that he is precluded and estopped from again raising this matter in this Court.

THE COURT: Overruled.

BY THE WITNESS:

A. No, sir.

Q. Mr. Garner, at any time during 1978 did you make any false statements of existing fact to Mr. John Henson?

A. No, sir.

MR. FRANKLIN: Same objection.

THE COURT: Same ruling.

BY MR. BARKER:

Q. Mr. Garner, during 1978 did you obtain any money from either Mr. Grogan or Mr. Henson on the basis of a misrepresentation?

MR. FRANKLIN: Your Honor, if I might have a continuing (p. 9) objection.

THE COURT: Certainly. You may.

MR. FRANKLIN: Thank you.

BY THE WITNESS:

A. No, sir.

Q. One other question, Mr. Garner. Did you injure either Mr. Grogan or Mr. Henson during 1978?

A. No, sir.

MR. BARKER: That's all.

THE COURT: You may inquire.

MR. FRANKLIN: No questions, Your Honor.

THE COURT: You may be excused.

MR. BARKER: Your Honor, defendant rests.

THE COURT: Very well. Anything further?

MR. FRANKLIN: Nothing, Your Honor.

THE COURT: You all have posed me a very pretty problem. Mr. Franklin, I don't know whether you have made a case or not. To some extent the Bankruptcy Court is the sole determiner of dischargability or not. A ruling of another tribunal, whether it be State or Federal, in some instances is not binding on the Bankruptcy Court. I'm going to have to, very frankly, gentlemen, do a little research because this is a problem I have not yet faced. I don't know how far I can go into the District Court file as it presently stands or what I can do. I will

take it under advisement. I will give you a (p. 10) written opinion, hopefully within a reasonable period of time. But I have to tell you in all honesty, I don't know the answer today. Thank you, gentlemen.

MR. BARKER: Your Honor, before we would conclude, I would like to point out one other thing.

THE COURT: Oh, yeah. Go ahead and then let me say another thing.

MR. BARKER: And that is simply that the civil judgement underlying is in three different counts and there has been, as far as I understand anyway, that civil judgment - the plaintiffs have some right of election on collection of that judgement and there has been no such election that I am aware of to date. I think that also affects the nature of the debt.

THE COURT: Okay.

MR. BARKER: Maybe I would - I guess what I am really saying is maybe the Court would allow us maybe 10 days to submit something on -

THE COURT: That is what I was going to add.

MR. BARKER: Try to help the Court.

THE COURT: Right. You have submitted a Trial Brief. Do you want to submit anything else or -

MR. FRANKLIN: I would like to reserve the right to respond to Mr. Barker's brief.

THE COURT: All right.

MR. BARKER: You filed a Trial Brief?

(p. 11) MR. FRANKLIN: Yes.

MR. BARKER: Did I get a copy?

MR. FRANKLIN: Served only yesterday.

MR. BARKER: I haven't seen it.

THE COURT: Why don't I give you say, about 20 days to file any brief you wish and 10 days for response? How would that be?

MR. FRANKLIN: Thank you.

THE COURT: 20 days to defendant for brief, 10 days for response. All right, gentlemen, thank you.

COURT IN RECESS AT 2:41 P.M.

\* \* \*

I CERTIFY THAT THE FOREGOING IS A CORRECT TRANSCRIPT OF THE RECORD OF PROCEEDINGS IN THE ABOVE ENTITLED MATTER.

/s/ Deanna J. Miller May 4, 1987

DEANNA J. MILLER

UNITED STATES DISTRICT COURT FOR THE  
WESTERN DISTRICT OF MISSOURI

Case No. 84-0516-CV-W-5

(Caption Omitted In Printing)

FIRST AMENDED COMPLAINT

As their claims for relief against the defendant Frank J. Garner, Jr., ("Garner"), the plaintiffs Coy Grogan ("Grogan") and John H. Henson ("Henson") state:

1. Grogan is an individual, a citizen of the United States, and is domiciled in Overland Park, Kansas; and Henson is an individual, a citizen of the United States, and is domiciled in El Reno, Oklahoma.

2. Garner is an individual, a citizen of the United States, and is domiciled in Kansas City, Missouri.

### COUNT I

3. Jurisdiction over Counts I, II, and IV is invoked pursuant to 28 U.S.C. § 1332, as the plaintiffs are respectively citizens of the states of Kansas and Oklahoma, and defendant is a citizen of the state of Missouri, and the amount of controversy in this action exceeds \$10,000.

4. In 1975 and 1976, Garner, Grogan, Henson, and others met, discussed, and agreed to organize a business (i) to inspect, repair, and refurbish railroad cars at several locations (the "Car Shops") and (ii) to mill and machine the wheels of railroad cars (the "Wheel Shop").

5. Garner, Grogan, Henson, and others were the original shareholders of Surface Transportation International, Inc., a Missouri corporation ("STI of Missouri"), organized in 1976 to operate the Car Shops and the Wheel Shop; and from the time of the organization of STI of Missouri it was agreed among the original shareholders that all opportunities for which the corporation was organized, including the operation of a Wheel Shop in the Kansas City metropolitan area, would be shared among the original shareholders in relative proportion to their shareholder interest.

6. Grogan and Henson each owned 10% of the common stock of STI of Missouri.

7. In 1978, Garner undertook to promote Surface Transportation International, Inc., a Kansas corporation ("STI of Kansas"), organized by Garner to operate the Wheel Shop.

8. In 1978, Garner represented to Grogan and Henson that:

(a) The sales price of the common stock of STI of Kansas was \$40,000 for each 1% of the stock.

(b) It was the intent of Garner to afford Grogan and Henson, among other original shareholders of STI of Missouri, the opportunity to purchase the same portion of common stock in STI of Kansas as they held in STI of Missouri;

(c) It was the intent of Garner that STI of Kansas would be organized as a subsidiary corporation of STI of Missouri with STI of Missouri to retain ownership of 20-30% of STI of Kansas.

(d) It was the intent of Garner that the price of all common stock in STI of Kansas, whether sold to original STI of Missouri shareholders or others, was to be \$40,000 for each 1% of the stock.

(e) The price of the common stock of STI of Kansas was set at \$40,000 per 1% because working capital was needed to invest in equipment, property, tools, and other items.

(f) The North America Car Corp. was offering to buy Surface Transportation International, Inc., and its subsidiaries, including the Wheel Shop, for \$300,000 in cash at closing and \$2 million in notes or stock paid over a 10 year period.

9. Garner's representations to Grogan and Henson were false in that at the time he made the representations:

(a) The sales price of the common stock of STI of Kansas was not \$40,000 for each 1% of the stock, rather, the stock was available for purchase by Garner, his family members and individuals in close association with Garner for little or no consideration;

(b) Garner intended to induce Grogan and Henson to forego the purchase of STI of Kansas stock by overstating the price of the stock;

(c) Garner intended to distribute the stock in STI of Kansas to himself, his family members, or to individuals in close association with Garner in return for no consideration or for a consideration substantially less than \$40,000 per 1% of stock;

(d) Garner did not intend to reserve 20-30% of the ownership in STI of Kansas in STI of Missouri;

(e) It was never the intent of Garner to raise working capital from the subscription of stock; rather Garner planned to obtain the working capital needed to purchase equipment, property, tools, and other items needed for operation of the Wheel Shop from the issue of industrial revenue bonds.

(f) Garner intended to arrange the sale of the Wheel Shop to North American Car Corp. in a transaction separate from the sale of Surface Transportation International, Inc. and other affiliated corporations, with Garner and others to receive stock valued at \$2.5 million in return for selling the Wheel Shop.

10. Garner knowingly made such false representations to induce Grogan and Henson to forego the purchase of stock in STI of Kansas.

11. At the time made, Grogan and Henson were unaware Garner's representations were false, and relying on Garner's representations concerning the distribution, the sale, and the price of STI of Kansas common stock, and his representation regarding the North American Car Corp. offer to purchase STI of Missouri and its affiliated companies, Grogan and Henson declined to exercise their contractual rights to purchase any common stock of STI of Kansas and approved the sale to North American Car Corp. of the stock of STI of Missouri.

12. Had Grogan or Henson known of the price at which Garner intended to sell stock in STI of Kansas and known of Garner's intention to transfer a significant portion of the ownership of STI of Kansas to himself, his family, or to those on whom he wished to bestow a benefit, each would have purchased 10% of the stock of STI of Kansas for the consideration for which the stock was sold or transferred.

13. As a direct and proximate result of Garner's misrepresentations, Grogan and Henson chose not to purchase stock in STI of Kansas and have thereby each been damaged; Garner acted willfully and maliciously in making the misrepresentations to Grogan and Henson and is liable to Grogan and Henson for punitive damages.

14. Until December of 1983, Grogan and Henson were unaware Garner's representations as to the sale of STI of Kansas stock and the sale of the Wheel Shop were false, and could not have discovered the representations

by reasonable diligence, because Garner offered the stock in STI of Kansas privately to selected individuals of his choice and concealed his offers and negotiations from Grogan and Henson. Grogan and Henson learned of Garner's misrepresentations only after it was revealed to them that certain individual shareholders of STI of Kansas did not pay \$40,000 for a 1% interest in the corporation as a result of litigation between Garner and the purchaser of STI of Kansas, which discussions occurred in December of 1983.

15. In December of 1978 all of the stock of STI of Kansas was sold for the aggregate price of \$2,537,825 and Garner received \$1,700,342.73 for his interest in STI of Kansas.

WHEREFORE, on Count I of this Complaint, Grogan requests judgment in his favor against Garner in the amount of \$250,000 in actual damages and \$500,000 in punitive damages, and his costs, and other appropriate relief in this action, and Henson requests judgment in his favor against Garner in the amount of \$250,000 in actual damages and \$500,000 in punitive damages, and his costs, and other appropriate relief in this action.

## COUNT II

16. Garner, because of his position as chief executive officer of STI of Missouri, his position as majority shareholder of STI of Missouri, his position as the incorporator and promoter of STI of Missouri and STI of Kansas, and his representations to Grogan and Henson that their interests in the wheel shop would not be diluted or lost, became a confident [sic] to Grogan and

Henson, and owed each a duty of fidelity and loyalty arising from the confidential relationship and fiduciary duties by virtue of Garner's position of control.

17. Garner breached his fiduciary duties to Grogan and Henson arising from their confidential relationships through the misrepresentations described in paragraph 8 above and by acquiring for himself, his family and for others who enjoyed his favor, the stock of STI of Kansas.

18. As the result of Garner's breach of his fiduciary duties arising from his confidential relationships with Grogan and Henson, Garner has been unjustly enriched in that Garner acquired and later sold 67% of the common stock in STI of Kansas, while preventing Grogan and Henson from acquiring the 10% stock to which each was entitled, and, Garner caused the distribution of shares in STI of Kansas to individuals who gave insufficient consideration for the stock.

WHEREFORE, on Count II of this Complaint, Grogan and Henson each request the Court: order an accounting of all proceeds Garner has received from the sale of STI of Kansas stock to which he is entitled because of the sale; enter judgment that Garner account to Grogan and Henson for all monies received by Garner through the sale of STI of Kansas stock; enter judgment against Garner for all sums found to be due Garner or Henson; impress a constructed trust upon assets of Garner purchased with money or property derived from the sale of stock in STI of Kansas; and grant Grogan and Henson such other relief as may be just together with the costs of this action.

### COUNT III

19. Jurisdiction over Count III is invoked pursuant to 15 U.S.C. § 78aa and 78f, and 28 U.S.C. § 1331.

20. Under the terms of the agreement described in paragraphs 4 and 5 above, Grogan and Henson each had the right to receive an ownership interest in the Wheel Shop proportionate to the interest each held in STI of Missouri.

21. Through the use of interstate mail or telephone calls, or otherwise through the use of an interstate instrumentality, Garner made the representations stated in paragraph 8 above.

22. The representations were false for the reasons stated in paragraph 9 above, and Garner made the representations with intent to deceive Grogan and Henson regarding the sale of stock in STI of Missouri and affiliated corporations in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

23. Relying on Garner's representations and as a direct result of Garner's representations, Grogan and Henson declined to exercise their contractual rights to purchase stock in STI of Kansas and have been thereby damaged.

WHEREFORE, on Count III of this Complaint, Grogan requests judgment in his favor and against Garner in the amount of \$250,000 in actual damages and for attorneys' fees and the costs relating to the prosecution of this action; and Henson requests judgment in his favor and against Garner in the amount of \$250,000 in actual

damages and for attorneys' fees and the costs relating to the prosecution of this action.

#### COUNT IV

24. The misrepresentations by Garner described in paragraphs 8 through 13 above constituted an offer to sell a security by means of an untrue statement of a material fact in violation of § 409.411(a)(2), R.S. Mo. 1978.

25. Grogan and Henson are entitled to damages for Garner's violation of § 409.411(a)(2).

WHEREFORE, on Count IV of this Complaint, Grogan requests judgment in his favor and against Garner in the amount of \$250,000 and an award of attorneys' fees and the costs relating to the prosecution of this action; and Henson requests judgment in his favor and against Garner in the amount of \$250,000 and for an award of attorneys' fees and the costs relating to the prosecution of this action.

#### COUNT V

26. Jurisdiction over Count IV is invoked pursuant to 18 U.S.C. § 1964 and 28 U.S.C. § 1331.

27. In a letter to Grogan and in a letter to Henson both dated May 12, 1978, Garner made the representations in paragraph 8 above.

28. Garner caused the two letters to be delivered by the United States Postal Service in furtherance of a scheme or artifice, as described in 18 U.S.C. § 1341, devised by Garner with the intent to [sic] assume

unlawfully the ownership and control over the Wheel Shop, a property and right of STI of Missouri and a corporation in which Grogan and Henson were shareholders.

29. Garner's incorporation of STI of Kansas to acquire ownership and control over the wheel shop constituted the engagement of an enterprise, as defined in 18 U.S.C. § 1961 (4), in interstate commerce with the intent to cause commercial injury through the unlawful acquisition of control in violation of 18 U.S.C. § 1962 (c).

30. Garner's use of the Postal Service to deliver the two letters and other documents constituted two separate acts in violation of 18 U.S.C. § 1341, and constituted a pattern of unlawful activity in violation of 18 U.S.C. § 1961(5).

31. As a direct and proximate result of Garner's violation of 18 U.S.C. § 1962(c), Grogan and Henson have been individually damaged.

WHEREFORE, on Count V of this Complaint, Grogan requests judgment in his favor and against Garner in the amount of \$750,000 and an award of attorneys' fees and the costs relating to the prosecution of this action; and Henson requests judgment in his favor and against Garner in the amount of \$750,000 and for an award of attorneys' fees and the costs relating to the prosecution of this action.

(Signatures And Certificate Of Service  
Omitted In Printing)

UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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No. 85-2098WM

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(Caption Omitted In Printing)

APPEAL FROM THE UNITED STATES DISTRICT  
COURT  
FOR THE WESTERN DISTRICT OF MISSOURI

---

ADDENDUM TO  
BRIEF OF THE APPELLANT  
FRANK J. GARNER, JR.

---

UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

Appeals Court No. 85-2098WM

(Caption Omitted In Printing)

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## JUDGMENT IN A CIVIL CASE

(FILED May 8, 1985)

## UNITED STATES DISTRICT COURT

## CASE TITLE

COY R. GROGAN, et al.,

Plaintiffs,

v.

FRANK J. GARNER, JR.,

Defendant.

## DISTRICT

WESTERN DISTRICT OF MISSOURI

## DOCKET NUMBER

84 - 0516 - CV - W - 5

## NAME OF JUDGE

SCOTT O. WRIGHT

X **Jury Verdict.** This action came before the Court and a jury with the judicial officer named above presiding. The issues have been tried and the jury has rendered its verdict.

— **Decision by Court.** This action came to trial or hearing before the Court with the judge (magistrate) named above presiding. The issues have been tried or heard and a decision has been rendered.

## IT IS ORDERED AND ADJUDGED

That on the claim of Coy Grogan against Frank J. Garner, Jr. for common law fraud, the jury unanimously

finds in favor of Coy Grogan and finds the actual damages at \$249,000.00 and assesses the punitive damages to be awarded to plaintiff Coy Grogan at \$24,900.00.

That on the claim of Coy Grogan against Frank J. Garner, Jr. for breach of fiduciary duty, the jury unanimously finds in favor of Coy Grogan and finds the actual damages at \$249,000.00.

That on the claim of Coy Grogan against Frank J. Garner, Jr. for violation of Securities Exchange Act of 1934, the jury unanimously finds in favor of Coy Grogan and finds the actual damages at \$249,000.00.

That on the claim of Coy Grogan against Frank J. Garner, Jr. for violation of Section 1962 of RICO, the jury unanimously finds in favor of Frank J. Garner, Jr. and finds actual damages to be none.

Entered On 5/8/85

ORIGINAL

CLERK

R.F. Connor

(BY) DEPUTY CLERK

C. Morrison

DATE

5/8/85

## JUDGMENT IN A CIVIL CASE

(FILED May 8, 1985)

UNITED STATES DISTRICT COURT

## CASE TITLE

COY R. GROGAN, et al.,

Plaintiffs,

v.

FRANK J. GARNER, JR.,

Defendant.

DISTRICT

WESTERN DISTRICT OF MISSOURI

DOCKET NUMBER

84 - 0516 - CV - W - 5

NAME OF JUDGE

SCOTT O. WRIGHT

X **Jury Verdict.** This action came before the Court and a jury with the judicial officer named above presiding. The issues have been tried and the jury has rendered its verdict.

— **Decision by Court.** This action came to trial or hearing before the Court with the judge (magistrate) named above presiding. The issues have been tried or heard and a decision has been rendered.

## IT IS ORDERED AND ADJUDGED

That on the claim of John Henson against Frank J. Garner, Jr. for common law fraud, the jury unanimously finds in favor of John Henson and finds the actual damages at \$249,000.00 and assesses the punitive damages to be awarded to plaintiff John Henson at \$24,900.00.

That on the claim of John Henson against Frank J. Garner, Jr. for breach of fiduciary duty, the jury unanimously finds in favor of John Henson and finds the actual damages at \$249,000.00.

That on the claim of John Henson against Frank J. Garner, Jr. for violation of Securities Exchange Act of 1934, the jury unanimously finds in favor of John Henson and finds the actual damages at \$249,000.00.

That on the claim of John Henson against Frank J. Garner, Jr. for violation of Section 1962 of RICO, the jury unanimously finds in favor of Frank J. Garner, Jr. and finds the actual damages to be none.

Entered 5/8/85

ORIGINAL

CLERK

R. F. CONNOR

(BY) DEPUTY CLERK

C. MORRISON

DATE

5/8/85

IN THE UNITED STATES DISTRICT COURT FOR THE  
WESTERN DISTRICT OF MISSOURI  
WESTERN DIVISION

COY R. GROGAN and JOHN H.	)	
HENSON,	)	
	)	
Plaintiffs,	)	No. 84-0516-
	)	CV-W-5
vs.	)	
FRANK J. GARNER, JR.,	)	
	)	
Defendant.	)	

## ORDER

(Filed Aug. 7, 1985)

Pending before the Court are various post-trial motions. The Court will issue the following rulings:

1. Defendant's motion for judgment notwithstanding the verdict and alternative motion for a new trial will be overruled. The jury's verdict must be upheld if, viewing the evidence in a light most favorable to the prevailing party, reasonable jurors could differ as to the conclusions that could be drawn from the evidence. *McGee v. South Pemiscot School Dist.*, 712 F.2d 339, 343 (8th Cir. 1983). Here, there clearly was sufficient evidence to

support the jury's conclusion that defendant violated his fiduciary duty and intentionally defrauded plaintiffs. In addition, the Court stands by its evidentiary rulings and the jury instructions which were given in this case.

2. Defendant's motion to alter or amend the judgment to preclude the possibility of double recovery by plaintiff will be sustained, but defendant's motion will be overruled to the extent that it seeks to force an election of legal theories by plaintiffs. At the conclusion of trial, the jury returned verdicts in favor of plaintiffs on three of their four legal theories and awarded actual damages of \$249,000 to each plaintiff under each theory. In addition, the jury awarded \$24,900 in punitive damages to each plaintiff under their common law fraud theory. Plaintiffs concede that they are not entitled to more than one actual damage award because all three awards correspond to a single injury. The judgment herein will be modified to reflect that fact. Nevertheless, there is no reason to require plaintiffs to elect under which legal theory they will collect the judgment. So long as it is clear that plaintiffs may not recover more than \$249,000 in actual damages, there is no need to specify which theory this award is based on.

3. Plaintiff's motion for an award of prejudgment interest will be sustained *only* with respect to their claim under § 10(b) of the Securities Exchange Act of 1934. Plaintiffs concede that they cannot recover prejudgment interest with respect to their state law claims. See *Herberholt v. DePaul Community Health Center*, 648 S.W.2d 160, 162 (Mo. Ct. App. 1983) (prejudgment interest disallowed on claims for unliquidated damages). Nevertheless, plaintiffs contend that an award of prejudgment interest on

their federal securities fraud claim is appropriate in order to prevent the unjust enrichment of defendant. The Court agrees. While state law governs the issue of prejudgment interest on state law claims, see *Weitz Co. v. Mo-Kan Carpet, Inc.*, 723 F.2d 1382, 1385 (8th Cir. 1983), federal law applies with respect to federal claims. As a matter of federal law, "prejudgment interest is not recovered according to a rigid theory of compensation for money withheld, but is given in response to considerations of fairness." *Blau v. Lehman*, 368 U.S. 403, 414 (1962). Although prejudgment interest should not be allowed "when its exaction would be inequitable," *id.*, it should be allowed whenever necessary to prevent the unjust enrichment of the defendant. See *Hodgson v. American Can Co.*, 440 F.2d 916, 920 (8th Cir. 1971); see also *General Facilities, Inc. v. National Marine Service, Inc.*, 664 F.2d 672, 674 (8th Cir. 1981). The decision of whether to award prejudgment interest is a matter of discretion for the trial court. *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 744 (8th Cir. 1965). Here, the Court finds that the damages sustained by plaintiffs were reasonably capable of ascertainment at the time of the illegal act. In addition, the Court believes that an award of prejudgment interest is necessary in order to fully compensate plaintiffs and to prevent the unjust enrichment of defendant. It bears emphasis that defendant has had the unfettered use of the ill-gotten money between the time of the illegal act and the date of the judgment. Under these circumstances, the Court will sustain plaintiffs' motion for an award of prejudgment interest between April 17, 1979 and the date of the judgment herein at a rate of nine percent per annum. See *Folz v. Marriott Corp.*, 594 F. Supp. 1007,

1016-17 (W.D. Mo. 1984); see generally *Behlar v. Smith*, 719 F.2d 950, 954 (8th Cir. 1983).

In accordance with the foregoing, it is hereby

ORDERED that defendant's motion for judgment notwithstanding the verdict and alternative motion for a new trial are overruled. It is further

ORDERED that defendant's motion to alter or amend the judgment is sustained in part and overruled in part. The judgment is amended to provide that each plaintiff may not recover more than \$249,000 for actual damages. However, plaintiffs need not specify the legal theory under which they will collect their judgments. It is further

ORDERED that plaintiffs' motion for awards of prejudgment interest on their claims under § 10(b) of the Securities Exchange Act of 1934 is sustained. Each plaintiff is entitled to prejudgment interest in the amount of nine percent per annum beginning April 17, 1979, on their § 10(b) claims only. No prejudgment interest is allowed on plaintiffs' state law claims. It is further

ORDERED defendant's motion for an enlargement of time to file suggestions in opposition to plaintiffs' motion for prejudgment interest is sustained and the same shall be deemed filed May 21, 1985. It is further

ORDERED that defendant's motion for a stay of execution is overruled as being moot. It is further

ORDERED that defendant's motion to quash, filed July 29, 1985, is overruled as being moot.

/s/ Scott O. Wright  
SCOTT O. WRIGHT

UNITED STATES DISTRICT  
JUDGE

August 7, 1985.

AMENDED  
JUDGMENT IN A CIVIL CASE  
(Filed Aug. 21, 1985)

UNITED STATES DISTRICT COURT

CASE TITLE

Coy Grogan, et al

v.

Frank J. Garner

DISTRICT

WESTERN DISTRICT OF MISSOURI

DOCKET NUMBER

84-0516-CV-W-5

NAME OF JUDGE OR MAGISTRATE

Scott O. Wright

X **Jury Verdict.** This action came before the Court and a jury with the judicial officer named above presiding. The issues have been tried and the jury has rendered its verdict.

— **Decision by Court.** This action came to trial or hearing before the Court with the judge (magistrate) named above presiding. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

The judgment of May 1, 1985 having been entered on the docket on May 8, 1985, it is hereby amended and clarified to provide that each plaintiff may not recover more than \$249,000 for actual damages. However, plaintiffs need not specify the legal theory under which they will collect their judgments. Each plaintiff is entitled to prejudgment interest in the amount of nine percent (9%) per annum beginning April 17, 1979, on their § (b) of the Securities Exchange Act of 1934 claims only. No prejudgment interest is allowed on plaintiffs' state law claims.

Entered on 8/21/85

CLERK

R. F. Connor

(BY) DEPUTY CLERK

Don Hendrix

---

DATE

8/21/85

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#### INSTRUCTION NUMBER 4A

Upon returning to the jury room, you will select one of your number to act as your foreperson. The foreperson will preside over your deliberations, and will be your spokesman here in court.

The court has prepared separate Forms of Verdict with respect to the claims of each plaintiff, which forms of verdict contain directions for completion and will allow you to return permissible verdicts in this case.

Plaintiffs seek to recover damages for each separate claim asserted by them, whether based on common law fraud, breach of fiduciary duty, or federal statutes. You should consider the question of actual damages only with respect to those claims on which you find the issues in favor of the plaintiff or plaintiffs. If you find the issues in favor of a plaintiff on more than one of his claims, the damages which you may find may be based on the same economic injury. The law does not permit a plaintiff to recover more than once for an economic injury, regardless of the number of claims or the legal theories on which the right to damages is based. However, if you find the issues

in favor either [sic] plaintiff on more than one of their respective claims, you should not attempt to apportion or divide the total amount of damages between such claims. You should consider and determine the total amount of damages separately with respect to each claim on which you find the issues in favor of plaintiffs. The court will take the necessary action after you return a verdict to avoid the possibility of awarding plaintiffs more than the total amount of their actual damages if you return a verdict for plaintiffs on more than one of their claims.

You will take these forms to the jury room and, when you have reached unanimous agreement as to your verdict with respect to each of the claims of each of the plaintiffs, you will have your foreperson fill in, date and sign the form which sets forth the verdict upon which unanimously [sic] agree; and then return with your verdict to the courtroom.

Devitt & Blackmar § 74.04

Submitted by Plaintiffs

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#### INSTRUCTION NUMBER 6

Your verdict must be for the plaintiff Grogan on his claim of the common law fraud for misrepresentation if you believe:

First: The defendant represented to plaintiff Grogan that North American Car Corp. was offering to buy Surface Transportation International, and its subsidiaries, including the Wheel Shop, for approximately \$2.3 million, intending that plaintiff Grogan rely

upon such representation in approving the acquisition of Surface Transportation International, Inc. by North American Car Corporation; and

Second: That the representation was false; and

Third: That the defendant knew his representation was false; and

Fourth: That this representation was material to plaintiff Grogan's decision to approve the acquisition of Surface Transportation International, Inc. by North American Car Corp.; and

Fifth: That plaintiff Grogan relied on defendant's representation in deciding to approve the acquisition of Surface Transportation International, Inc. by North American Car Corp.; and

Sixth: That as a direct result of such representation plaintiff Grogan sustained damages;

Your verdict must be for the defendant on plaintiff Grogan's claims of common law fraud if you believe plaintiff Grogan actually discovered the alleged acts of fraud before May 7, 1979.

#### INSTRUCTION NUMBER 7

Your verdict must be for the plaintiff Grogan on his claim of common law fraud for failure to disclose material facts if you believe:

First: The defendant failed to disclose to plaintiff Grogan that defendant and others who would purchase stock in the wheel shop would receive an additional payment of approximately \$2.5 million for their stock; and

Second: That defendant failed to disclose these facts intending that plaintiff Grogan not be informed of such facts in deciding whether to approve the acquisition of Surface Transportation International, Inc., by North American Car Corp.; and

Third: These facts were substantially likely to affect or influence the plaintiff Grogan's decision to approve the acquisition of Surface Transportation International, Inc. to North American Car Corp.; and

Fourth: As a direct result of the failure to disclose these facts plaintiff Grogan was damaged;

Your verdict must be for the defendant on plaintiff Grogan's claims of common law fraud if you believe plaintiff Grogan actually discovered the alleged acts of fraud before May 7, 1979.

#### INSTRUCTION NUMBER 8

Your verdict must be for plaintiff Grogan on his claim of breach of fiduciary duty if the believe:

First: That defendant:

(1) represented to plaintiff Grogan that the sale of the stock of Surface Transportation International, Inc. to North American Corporation included the sale of the Wheel Shop, with the intention of inducing plaintiff Grogan to approve an acquisition in which the defendant profited in a manner not revealed to plaintiff Grogan, or

(2) failed to disclose to plaintiff Grogan that the defendant, and others with his consent, would purchase stock in the Wheel Shop for \$1.00 per share, with the intention of selling that stock to

North American Car Corporation at a substantial profit at the same time the plaintiff Grogan sold his stock in Surface Transportation International, Inc., and

Second: By engaging in one or both of these acts or omissions, defendant failed to discharge fiduciary duties he owed to plaintiff Grogan as described in Instruction 9; and

Third: As a direct result of such acts, plaintiff Grogan was damaged;

Unless you believe plaintiff is not entitled to recover by reason of Instruction Number 10.

---

#### INSTRUCTION NUMBER 9

A director or officer of a corporation is a fiduciary to the corporation and to its shareholders. A fiduciary occupies a position of highest trust and confidence, and the utmost good faith is required when an officer or director exercises powers conferred by the corporation.

The fiduciary duties of an officer or director of a stock corporation include the following:

1. An officer or director may not cause issuance of stock for personal gain if the activities are to the detriment of the shareholders.

2. An officer or director has a duty to disclose fully and fairly all material facts to shareholders concerning transactions of the shareholder in stock of the company. Material facts are facts which are substantially likely to

affect a reasonable shareholder's decision in connection with the sale of her or his stock. This also means an officer or director has a continuing duty to disclose material facts so long as the facts are material to the shareholder's dealings in the stock of the corporation. If material facts change then the officer or director has a duty to reveal the changed circumstances.

3. A corporate officer or director is under a fiduciary duty not to divert a corporate business opportunity for his personal gain. In other words, if a business opportunity exists, an officer or director may not appropriate it for himself or divert it to another business entity in which he has an interest if the business opportunity presented is: (i) closely related to the business of the corporation, (ii) one which the corporation might naturally be expected to expend, (iii) one in which the corporation has the financial ability to undertake and (iv) includes activities as to which the corporation has fundamental knowledge, practical experience, facilities, equipment, personnel and the ability to pursue.

4. A corporate director or officer will not be permitted to make a private or secret profit from his official position with the corporation. Officers and directors occupy a trust relationship with the corporation's shareholders, and any personal profit of officers or directors at the expense of the shareholders violates the fiduciary duty unless good faith and fairness in the dealing appear from the evidence.

---

## INSTRUCTION NUMBER 10

Your verdict must be for the defendant on plaintiff Grogan's claim of breach of fiduciary duties if you believe plaintiff actually discovered or, in the exercise of reasonable diligence, should have discovered defendant's breach of his fiduciary duties before May 7, 1979.

## INSTRUCTION NUMBER 11

It is unlawful under Section 10(b) of the Securities and Exchange Act of 1934 to do any of the following things, directly or indirectly, in connection with the purchase or sale of any security:

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

## INSTRUCTION NUMBER 12

Your verdict must be for plaintiff Grogan on his claim the defendant violated § 10(b) of the Securities Exchange Act of 1934 if you believe:

*First:* That the defendant:

(1) knowingly failed to disclose to plaintiff Grogan that stock in the Wheel Shop would be sold to other individuals at a purchase price substantially less than the offer to plaintiff, intending to conceal this information from plaintiff Grogan to induce him to approve the sale of his stock in Surface Transportation International, Inc. to North American Car Corp.; or

(2) knowingly misrepresented to plaintiff Grogan that Surface Transportation International, Inc., and its subsidiaries, including the Wheel Shop, were to be sold to North American Car Corporation for approximately \$2.3 million, intending to mislead or deceive plaintiff Grogan into believing that the Wheel Shop was part of the sales transaction for which he would receive his proportionate share as a stockholder of Surface Transportation International, Inc.; or

(3) knowingly failed to disclose to plaintiff Grogan that the Wheel Shop was to be sold for an additional payment of approximately \$2.5 million at the same time that Surface Transportation International, Inc. was to be sold, intending that the plaintiff Grogan would be misled or deceived and would approve the sale of his stock in Surface Transportation International, Inc. to North American Car Corp. without knowledge of the Wheel Shop transaction; and

*Second:* There is a substantial likelihood that the facts which were misrepresented or concealed by defendant are facts on which a reasonable person would have relied; and

*Third:* That, in making the decision to sell his stock in Surface Transportation International, Inc., plaintiff Grogan relied on such statements of defendant; and

*Fourth:* That, as a direct result of defendant's conduct as submitted in this instruction, plaintiff Grogan was damaged;

Unless you believe the plaintiff is not entitled to recover by reason of Instruction Number 13.

An act or omission is 'knowingly' done if done voluntarily and intentionally, and not because of a mistake or accident or other innocent reason.

---

#### INSTRUCTION NUMBER 13

Your verdict must be for the defendant on plaintiff Grogan's claim of violation of § 10(b) of the Securities Exchange Act of 1934 if you believe plaintiff Grogan actually discovered or in the exercise of reasonable diligence, should have discovered the alleged violation or violations of the federal securities law before May 7, 1982.

---

#### INSTRUCTION NUMBER 20

In the event you find in favor of the plaintiff Grogan on one or more of his claims against defendant, then you must consider the question of damages with respect to each claim on which you find in favor of the plaintiff Grogan. Damages may not be based on speculation, and the burden is on the plaintiff Grogan to prove the damage claimed.

However, the burden on the plaintiff to prove his damages by a preponderance of the evidence does not require that he prove with mathematical precision the exact sum of his damage, but only that he furnish evidence of such facts and circumstances to permit an intelligent and probable estimate of those damages.

In this case, the plaintiff Grogan claims that the acts of the defendant submitted to you in these instructions caused him to obtain less for his stock in Surface Transportation International, Inc. than he would have received but for the conduct of the defendant. The correct measure of damages in this case is the difference between the fair value of all that plaintiff Grogan received in connection with the sale of his stock in Surface Transportation International, Inc. and the fair value of what he would have received had there been no unlawful conduct on the part of defendant.

---

#### INSTRUCTION NUMBER 21

If you find the issues in favor of the plaintiff Grogan on his claims against defendant based on common law fraud, and if you believe the conduct of the defendant as submitted to you in my instructions with respect to common law fraud was willful, wanton, or malicious, then, in addition to any actual damages to which you find plaintiff or plaintiffs entitled based on the claim of common law fraud, you may also award the plaintiff an additional amount as punitive damages in such sum as you believe

will serve to punish defendant and to deter him and others from like conduct.

The term "malicious" as used in this instruction does not mean hatred, spite, or ill will, as commonly understood, but means the doing of a wrongful act intentionally without just cause or excuse.

---

#### VERDICT A

##### COMMON LAW FRAUD

On the claim of Coy Grogan against Frank J. Garner, Jr. for common law fraud, we unanimously find in favor of:

---

(List either Coy Grogan or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff Coy Grogan

We unanimously find the actual damages of plaintiff Coy Grogan on his claim for common law fraud at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

We unanimously assess the punitive damages to be awarded to plaintiff Coy Grogan at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

##### BREACH OF FIDUCIARY DUTY

On the claim of Coy Grogan against Frank J. Garner, Jr. for breach of fiduciary duty, we unanimously find in favor of:

---

(List either Coy Grogan or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff Coy Grogan

We unanimously find the actual damages of plaintiff Coy Grogan on his claim for breach of fiduciary duty at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

##### VIOLATION OF SECURITIES EXCHANGE ACT OF 1934

On the claim of John Henson against Frank J. Garner, Jr. for violation of Securities Exchange Act of 1934, we unanimously find in favor of:

---

(List either John Henson or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff John Henson

We unanimously find the actual damages of plaintiff John Henson on his claim for violation of Securities Exchange Act of 1934 at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

## CIVIL RICO

On the claim of John Henson against Frank J. Garner, Jr. for violation of Section 1962 of RICO, we unanimously find in favor of:

---

(List either John Henson or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff John Henson

We unanimously find the actual damages of plaintiff John Henson on his claim for violation of Section 1962 of RICO at \$ \_\_\_\_\_ (stating amount or, if none, write the word "none").

The foregoing is the unanimous verdict of the jury.

---

Foreperson

Date: \_\_\_\_\_

---

## INSTRUCTION NUMBER 23

Your verdict must be for the plaintiff Henson on his claim of the common law fraud for misrepresentation if you believe:

*First:* The defendant represented to plaintiff Henson that North American Car Corp. was offering to buy Surface Transportation International, and its subsidiaries, including the Wheel

Shop, for approximately \$2.3 million, intending that plaintiff Henson rely upon such representation in approving the acquisition of Surface Transportation International, Inc. by North American Car Corporation; and

*Second:* That the representation was false; and

*Third:* That the defendant knew his representation was false; and

*Fourth:* That this representation was material to plaintiff Henson's decision to approve the acquisition of Surface Transportation International, Inc. by North American Car Corp.; and

*Fifth:* That plaintiff Henson relied on defendant's representation in deciding to approve the acquisition of Surface Transportation International, Inc. by North American Car Corp.; and

*Sixth:* That as a direct result of such representation plaintiff Henson sustained damages;

Your verdict must be for the defendant on plaintiff Henson's claims of common law fraud if you believe plaintiff Henson actually discovered the alleged acts of fraud before May 7, 1979.

---

## INSTRUCTION NUMBER 24

Your verdict must be for the plaintiff Henson on his claim of common law fraud for failure to disclose material facts if you believe:

*First:* The defendant failed to disclose to plaintiff Henson that defendant and others who would purchase stock in the wheel shop would receive

an additional payment of approximately \$2.5 million for their stock; and

*Second:* That defendant failed to disclose these facts intending that plaintiff Henson not be informed of such facts in deciding whether to approve the acquisition of Surface Transportation International, Inc., by North American Car Corp.; and

*Third:* These facts were substantially likely to affect or influence the plaintiff Henson's decision to approve the acquisition of Surface Transportation International, Inc. to North American Car Corp.; and

*Fourth:* As a direct result of the failure to disclose these facts plaintiff Henson was damaged;

Your verdict must be for the defendant on plaintiff Henson's claims of common law fraud if you believe plaintiff Henson actually discovered the alleged acts of fraud before May 7, 1979.

---

#### INSTRUCTION NUMBER 25

Your verdict must be for plaintiff Henson on his claim of breach of fiduciary duty if you believe:

*First:* That defendant

(1) represented to plaintiff Henson that the sale of the stock of Surface Transportation International, Inc. to North American Car Corporation included the sale of the Wheel Shop, with the intention of inducing plaintiff Henson to approve an acquisition in

which the defendant profited in a manner not revealed to plaintiff Henson, or

(2) failed to disclose to plaintiff Henson that the defendant, and others with his consent, would purchase stock in the Wheel Shop for \$1.00 per share, with the intention of selling that stock to North American Car Corporation at a substantial profit at the same time the plaintiff Henson sold his stock in Surface Transportation International, Inc., and

*Second:* By engaging in one or both of these acts or omissions, defendant failed to discharge fiduciary duties he owed to plaintiff Henson as described in Instruction 26; and

*Third:* As a direct result of such acts, plaintiff Henson was damaged;

Unless you believe the plaintiff is not entitled to recover by reason of Instruction Number 27.

---

#### INSTRUCTION NUMBER 26

A director or officer of a corporation is a fiduciary to the corporation and to its shareholders. A fiduciary occupies a position of highest trust and confidence, and the utmost good faith is required when an officer or director exercises powers conferred by the corporation.

The fiduciary duties of an officer or director of a stock corporation include the following:

1. An officer or director may not cause issuance of stock for personal gain in the activities are to the detriment of the shareholders.

2. An officer or director has a duty to disclose fully and fairly all material facts to shareholders concerning transactions of the shareholder in stock of the company. Material facts are facts which are substantially likely to affect a reasonable shareholder's decision in connection with the sale of her or his stock. This also means an officer or director has a continuing duty to disclose material facts so long as the facts are material to the shareholder's dealings in the stock of the corporation. If material facts change then the officer or director has a duty to reveal the changed circumstances.

3. A corporate officer or director is under a fiduciary duty not to divert a corporate business opportunity for his personal gain. In other words, if a business opportunity exists, an officer or director may not appropriate it for himself or divert it to another business entity in which he has an interest if the business opportunity presented is: (i) closely related to the business of the corporation, (ii) one which the corporation might naturally be expected to expend, (iii) one in which the corporation has the financial ability to undertake and (iv) includes activities as to which the corporation has fundamental knowledge, practical experience, facilities, equipment, personnel and the ability to pursue.

4. A corporate director or officer will not be permitted to make a private or secret profit from his official position with the corporation. Officers and directors

occupy a trust relationship with the corporation's shareholders, and any personal profit of officers or directors at the expense of the shareholders violates the fiduciary duty unless good faith and fairness in the dealing appear from the evidence.

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#### INSTRUCTION NUMBER 27

Your verdict must be for the defendant on plaintiff Henson's claim of breach of fiduciary duties if you believe plaintiff actually discovered or, in the exercise of reasonable diligence, should have discovered defendant's breach of his fiduciary duties before May 7, 1979.

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#### INSTRUCTION NUMBER 28

It is unlawful under Section 10(b) of the Securities and Exchange Act of 1934 to do any of the following things, directly or indirectly, in connection with the purchase or sale of any security:

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

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#### INSTRUCTION NUMBER 29

Your verdict must be for plaintiff Henson on his claim the defendant violated § 10(b) of the Securities Exchange Act of 1934 if you believe:

*First:* That the defendant:

(1) knowingly failed to disclose to plaintiff Henson that stock in the Wheel Shop would be sold to other individuals at a purchase price substantially less than the offer to plaintiff, intending to conceal this information from plaintiff Henson to induce him to approve the sale of his stock in Surface Transportation International, Inc. to North American Car Corp.; or

(2) knowingly misrepresented to plaintiff Henson that Surface Transportation International, Inc., and its subsidiaries, including the Wheel Shop, were to be sold to North American Car Corporation for approximately \$2.3 million, intending to mislead or deceive plaintiff Henson into believing that the Wheel Shop was part of the sales transaction for which he would receive his proportionate share as a stockholder of Surface Transportation International, Inc.; or

(3) knowingly failed to disclose to plaintiff Henson that the Wheel Shop was to be sold for an additional payment of approximately \$2.5 million at the same time that Surface Transportation International, Inc. was to be sold, intending that the plaintiff Henson would be misled or deceived and would approve the sale of his stock in Surface Transportation International,

Inc. to North American Car Corp. without knowledge of the Wheel Shop transaction; and

*Second:* There is a substantial likelihood that the facts which were misrepresented or concealed by defendant are facts on which a reasonable person would have relied; and

*Third:* That, in making the decision to sell his stock in Surface Transportation International, Inc., plaintiff Henson relied on such statements of defendant; and

*Fourth:* That, as a direct result of defendant's conduct as submitted in this instruction, plaintiff Henson was damaged;

Unless you believe the plaintiff is not entitled to recover by reason of Instruction Number 30.

An act or omission is 'knowingly' done if done voluntarily and intentionally, and not because of a mistake or accident or other innocent reason.

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#### INSTRUCTION NUMBER 30

Your verdict must be for the defendant on plaintiff Henson's claim of violation of § 10(b) of the Securities Exchange Act of 1934 if you believe plaintiff Henson actually discovered or in the exercise of reasonable diligence, should have discovered the alleged violation or violations of the federal securities law before May 7, 1982.

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## INSTRUCTION NUMBER 37

In the event you find in favor of the plaintiff Henson on one or more of his claims against defendant, then you must consider the question of damages with respect to each claim on which you find in favor of the plaintiff Henson. Damages may not be based on speculation, and the burden is on the plaintiff Henson to prove the damage claimed.

However, the burden on the plaintiff to prove his damages by a preponderance of the evidence does not require that he prove with mathematical precision the exact sum of his damage, but only that he furnish evidence of such facts and circumstances to permit an intelligent and probable estimate of those damages.

In this case, the plaintiff Henson claims that the acts of the defendant submitted to you in these instructions caused him to obtain less for his stock in Surface Transportation International, Inc. than he would have received but for the conduct of the defendant. The correct measure of damages in this case is the difference between the fair value of all that plaintiff Henson received in connection with the sale of his stock in Surface Transportation International, Inc. and the fair value of what he would have received had there been no unlawful conduct on the part of defendant.

## INSTRUCTION NUMBER 38

If you find the issues in favor of the plaintiff Henson on his claims against defendant based on common law fraud, and if you believe the conduct of the defendant as submitted to you in my instructions with respect to common law fraud was willful, wanton, or malicious, then, in addition to any actual damages to which you find plaintiff or plaintiffs entitled based on the claim of common law fraud, you may also award the plaintiff an additional amount as punitive damages in such sum as you believe will serve to punish defendant and to deter him and others from like conduct.

The term "malicious" as used in this instruction does not mean hatred, spite, or ill will, as commonly understood, but means the doing of a wrongful act intentionally without just cause or excuse.

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 VERDICT B

## COMMON LAW FRAUD

On the claim of John Henson against Frank J. Garner, Jr. for common law fraud, we unanimously find in favor of:

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(List either John Henson or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff John Henson

We unanimously find the actual damages of plaintiff John Henson on his claim for common law fraud at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

We unanimously assess the punitive damages to be awarded to plaintiff John Henson at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

#### BREACH OF FIDUCIARY DUTY

On the claim of John Henson against Frank J. Garner, Jr. for breach of fiduciary duty, we unanimously find in favor of:

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(List either John Henson or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff John Henson

We unanimously find the actual damages of plaintiff John Henson on his claim for breach of fiduciary duty at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

#### VIOLATION OF SECURITIES EXCHANGE ACT OF 1934

On the claim of Coy Grogan against Frank J. Garner, Jr. for violation of Securities Exchange Act of 1934, we unanimously find in favor of:

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(List either Coy Grogan or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff Coy Grogan

We unanimously find the actual damages of plaintiff Coy Grogan on his claim for violation of Securities Exchange Act of 1934 at \$\_\_\_\_\_ (stating amount).

#### CIVIL RICO

On the claim of Coy Grogan against Frank J. Garner, Jr. for violation of Section 1962 of RICO, we unanimously find in favor of:

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(List either Coy Grogan or Frank J. Garner, Jr.)

Note: Complete the following paragraph only if the above finding is in favor of plaintiff Coy Grogan

We unanimously find the actual damages of plaintiff Coy Grogan on his claim for violation of Section 1962 of RICO at \$\_\_\_\_\_ (stating amount or, if none, write the word "none").

The foregoing is the unanimous verdict of the jury.

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Foreperson

Date: \_\_\_\_\_

UNITED STATE COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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No. 85-2098

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(Caption Omitted in Printing)  
Appeal from the United States  
District Court for the  
Western District of Missouri.

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Submitted: June 9, 1986  
Filed: December 8, 1986

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Before LAY, Chief Judge, ARNOLD, Circuit Judge, and  
STROM,\* District Judge.

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LAY, Chief Judge.

Coy R. Grogan and John H. Henson brought this  
diversity action against Frank J. Garner, Jr., alleging that

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\* The HONORABLE LYLE E. STROM, United States Dis-  
trict Judge for the District of Nebraska, sitting by designation.

Garner committed common law fraud, breached his  
fiduciary duties, and violated § 10(b) of the Securities  
Exchange Act of 1934. The suit arises from the sale by  
Garner of stock in STI-Kansas to North American Car  
Corporation (NACC). A jury returned a verdict for  
Grogan and Henson and awarded \$249,000 actual damage  
on each of three counts as well as punitive damages of  
\$24,900 on the fraud claim.

After the jury returned its verdict and the judgment  
was filed, Grogan and Henson filed a motion for an  
award of prejudgment interest on the judgment. Garner  
moved for a judgment notwithstanding the verdict or a  
new trial and to amend the judgment as duplicitous. The  
court<sup>1</sup> held that Grogan and Henson individually could  
receive no more than \$249,000 in actual damages and  
\$24,900 for punitive damages on the fraud claim but did  
not require the plaintiffs to elect the count upon which  
the judgment for actual damages was based. The court  
also awarded prejudgment interest only as to the § 10(b)  
claim at nine percent per annum from April 17, 1979, to  
the date of the judgment. Garner appeals.

#### Facts

Our review of the record in the light most favorable  
to the verdict holder, *Lowe v. E.I. Dupont DeNemours Co.*,  
802 F.2d 310, 311 (8th Cir. 1986), reveals the following

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<sup>1</sup> The Honorable Scott O. Wright, United States District  
Court for the Western District of Missouri, presiding.

facts. STI-Missouri was a Missouri corporation established by Frank Garner, Jr., in 1976. Garner's son, Franklin III, originally the sole stockholder and president of the corporation. The elder Garner eventually began working full-time for STI-Missouri, at which time his son relinquished all capital stock in the corporation to his father. In 1976, Garner invited both Grogan and Henson to join STI-Missouri as employees in return for 100 shares, approximately ten percent, of the company stock. Grogan and Henson accepted the offer and paid approximately \$800 each for their shares. At the same time, several other individuals also became minority shareholders in the corporation.<sup>2</sup> Garner retained approximately fifty-five percent of STI-Missouri shares, and until the time the corporation was sold, he served as president and chief executive officer.

In 1977, Garner began investigating the possibility of forming a wheel shop to supply wheels for the railcars that STI-Missouri repaired and refurbished. Garner estimated that startup costs would total 3.5 to 4 million dollars. However, he needed \$50,000 immediately for a down payment on equipment and construction. Garner

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<sup>2</sup> STI-Missouri shares were distributed as follows:

Frank Garner, Jr. - 600 shares  
 John Buffalo - 100 shares  
 Tom Garner - 100 shares  
 Coy Grogan - 100 shares  
 John Henson - 100 shares  
 Raymond Guzak - 25 shares  
 Robert Guzak - 25 shares  
 Charles Pitts - 25 shares  
 Douglas Weitzman - 25 shares

obtained the approval of STI-Missouri shareholders to have STI-Missouri borrow \$100,000 so that funds could be loaned to STI-Kansas by STI-Missouri.<sup>3</sup> The STI-Kansas debt was carried as an account receivable on STI-Missouri's books, thereby enhancing the net worth of STI-Missouri.

In January, 1978, NACC expressed to Garner its interest in buying STI-Missouri's car shops, which by then were located in several states. After two and one-half months of negotiations, NACC discontinued its efforts to buy the company. At the same time, Garner was still attempting to raise working capital for STI-Kansas. He notified all STI-Missouri shareholders in May, 1978, that he would like to incorporate STI-Kansas and that shareholders of STI-Missouri could purchase one percent of STI-Kansas for \$40,000, with STI-Missouri retaining twenty to thirty percent of STI-Kansas stock. All STI-Missouri shareholders, including Grogan and Henson, declined Garner's offer, and Garner did not further pursue this plan.

On October 10, 1978, Garner notified all shareholders of the annual STI-Missouri shareholders meeting. In his letter, Garner stated that the meeting was for the purpose of reviewing the company's financial position and discussing the status of the wheel shop and other subsidiary car shops. In the meantime, NACC had expressed renewed interest in purchasing STI-Missouri and its affiliates, including the wheel shop. On October 17, 1978,

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<sup>3</sup> Garner collateralized the loan with personal farm property.

NACC presented Garner with a letter of intent to purchase STI-Missouri, a number of the car shops, and the wheel shop. The sale was subject to final approval of NACC's board of directors and all shareholders of the STI enterprise. Because he now had a firm offer from NACC, Garner testified, he contacted each STI-Missouri shareholder by telephone and urged him to attend the October 21 meeting. Both Grogan and Henson attended.

On September 26, 1978, approximately one month before the shareholders meeting, STI-Kansas was incorporated, with Garner as its sole shareholder. At the time of incorporation, STI-Kansas remained unfunded and indebted to STI-Missouri. Grogan and Henson both testified that they were unaware of either the incorporation or of Garner's status as sole stockholder. On September 30, Garner purchased 500 shares of STI-Kansas common stock for one dollar per share, and on October 17, he purchased another 170 shares at the same price.<sup>4</sup>

Although Garner at one time had offered one percent of STI-Kansas for \$40,000, he now determined, as reflected in a series of memos dated October 2, 1978, to distribute STI-Kansas stock to certain employees of the company in exchange for one dollar per share and an

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<sup>4</sup> The record is unclear whether Garner purchased more than 670 shares of STI-Kansas. The plaintiffs at one point state that Garner owned 840 shares before he distributed them as indicated below. This amount appears consistent with Garner's share at closing of stock in Tiger International, NACC's parent corporation, which was 67%.

employment commitment.<sup>5</sup> These transactions were completed on November 17, 1978, after the October 21 meeting but before closing the sale to NACC.

The parties' versions of what happened at the October 21 meeting differ substantially. Grogan and Henson testified that Garner represented to the shareholders that the 2.3 million dollar offer from NACC included the purchase of all STI facilities, including STI-Kansas.<sup>6</sup>

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<sup>5</sup> Garner distributed the shares of STI-Kansas stock as follows:

Tom Garner - 85 shares  
 John Buffalo - 80 shares  
 Frank Garner, III - 60 shares  
 Marge Garner - 25 shares  
 Pacey Wohlner - 25 shares  
 Gilbert Liebig - 25 shares  
 Russell DeBerg - 10 shares  
 Richard Jardine - 10 shares  
 Wayne Leigh - 10 shares

<sup>6</sup> Garner distributed the following proposal:

SURFACE TRANSPORTATION INTERNATIONAL, INC. has received an offer from North American Car Corporation to purchase 100% of the outstanding stock of STI. Therefore, the vote of the Stockholders must be unanimous in favor of the stock purchase if we are to proceed further with negotiations.

Anything less than 100% of the stockholders voting affirmatively will immediately stop further negotiations with regard to the sale of STI and its subsidiaries to North American Car Corporation. Each of you are admonished to fully understand what the offer would mean to you personally as a stockholder

(Continued on following page)

NACC's letter of intent which, according to Grogan and Henson, Garner never distributed, revealed that NACC offered to pay separately for STI-Kansas by a stock

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(Continued from previous page)

of STI before making your decision to sell or not to sell.

The subsidiaries to be included in the sale are:

- The Kansas City Car Shops (Two Shops, both Leased);
- The Ferriday Louisiana Shop;
- The Toledo Ohio Shop (Leased);
- The Superior, Wisconsin Shop;
- The South Dakota Facility - 10 year Management Contract;
- Assets and outstanding stock of S.T.I. Special Services;
- Assets and outstanding stock of Air and Surface Transportation International;
- Rail Transportation Specialists - 5 year Management Contract;
- S.T.I.X. Car Leasing (an inactive corporation)
- Assets of Wheel Shop (Not funded at this time)*  
[emphasis added]

I understand the offer STI and the above-listed subsidiaries is \$300,000 cash at closing and \$2 million in North American notes or Tiger International stock, or a combination of both notes and stock. The cash to be distributed equally at closing based upon percentage of ownership. (See attached Example).

Stock or notes to be paid over a 10-year period at 8% interest, payable in 10 equal payments, plus interest, with first payment to be July of 1979. (See attached Example).

(Continued on following page)

exchange and extended an employment offer to Garner. Ultimately, NACC swapped shares of its parent corporation, Tiger International, valued at over 2.5 million dollars, for shares of STI-Kansas. Grogan and Henson claim that they did not learn of the separate consideration tendered for STI-Kansas until 1983. Had they known of the full transaction, they claim, they would not have agreed to sell their stock to NACC.

Garner, on the other hand, presented evidence that he disclosed at the October 21 meeting that he was the sole shareholder in STI-Kansas and that he distributed NACC's letter of intent. He also testified that he offered both plaintiffs the opportunity to become employees of STI-Kansas, but both failed to pursue the offer. Garner and John Buffalo further testified that Grogan received and reviewed the sales agreement before the closing on December 28 and 29, 1978. Grogan denied this. Garner and others also testified that all STI shareholders received a memorandum dated December 4, 1978, which set out the separate consideration for STI-Kansas. The plaintiffs deny receiving this memo.

On December 28 and 29, 1978, NACC purchased both corporations. Grogan and Henson received approximately \$230,000 in cash and notes for their STI-Missouri stock. Besides cash and notes, Garner received for his

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(Continued from previous page)

I vote YES to accept the North American offer.

I vote NO to the offer of North American.

BY \_\_\_\_\_

Dated: October 21, 1978.

STI-Kansas shares Tiger International stock worth \$1,700,460 and an employment contract with NACC. Tom Garner and Jim Buffalo, the other two STI-Missouri shareholders also holding stock in STI-Kansas, received Tiger International stock worth \$215,730 and \$203,040 respectively. The remaining seven STI-Kansas shareholders received Tiger International stock valued at \$418,680. The total value of exchanged Tiger International stock was \$2,537,910.

### Discussion

Grogan and Henson claim they were not advised before, during, or after the October 21 meeting (1) that the wheel shop had been incorporated in September, 1978; (2) that STI-Kansas stock was sold for one dollar per share and employment commitments; (3) that those purchasing STI-Kansas stock from Garner were handpicked employees and relatives; and (4) that NACC paid a separate consideration, by way of Tiger International stock worth over 2.5 million dollars, for STI-Kansas. They allege that Garner misrepresented to them that the proposal of sale included the full consideration for both STI-Missouri and STI-Kansas. They urge that they were at all times led to believe that STI-Kansas was a division of STI-Missouri and that their ten percent interest in STI-Missouri properly included a proportionate interest in the assets of STI-Kansas. They therefore argue that they were entitled to ten percent of the value of the Tiger International stock, based on their ten percent ownership of STI-Missouri. Grogan and Henson claim they were individually defrauded when Garner misrepresented the terms of NACC's offer, and that by his actions, Garner breached a

fiduciary duty owed them and violated § 10(b) of the Securities Exchange Act of 1934.

Garner appeals, citing numerous errors that we will attempt to summarize: (1) the plaintiffs had no standing to sue because any injury sustained was to the corporation, requiring a derivative action; (2) the plaintiffs failed to prove sufficient evidence to sustain their claims for liability and damages; (3) the trial court committed various errors in its jury instructions; (4) the trial court erred in refusing to allow certain expert testimony; (5) the trial court erred in granting a post-verdict award of prejudgment interest on the § 10(b) claim; and (6) the trial court erred in not requiring the plaintiffs to elect among remedies.

### Standing - Derivative Suit

We turn initially to the question of whether the suit should have been brought as a derivative action. The parties agree that Missouri law controls the issue. Whether a suit is properly brought as an individual action turns on whether the plaintiff has suffered an injury distinct from one incurred by the corporation. As one commentator has observed, "[i]f the injury is one to the plaintiff as a stockholder and to him individually, and not to the corporation, as where the action is based on a contract to which he is a party, or on a right belonging severally to him, or on a fraud affecting him directly, it is an individual action." 12B Fletcher Cyclopaedia Corporations § 5911 (Perm. Ed. 1984) (emphasis added); see also *Gieselmann v. Stegeman*, 443 S.W.2d 127 (Mo. 1969). In such a case, an individual stockholder may sue to redress direct

injury to himself, even if the same violation also injured the corporation. 12B Fletcher *supra*.

In *Dawson v. Dawson*, 645 S.W.2d 120 (Mo. App. 1982), a shareholder in the corporation sued individually and derivatively for an injunction and an accounting regarding an alleged illegal stock transfer from a director to another stockholder. The plaintiff claimed standing based upon his characterization of the director owing a fiduciary duty to each shareholder. While agreeing that a director is in a fiduciary relationship with shareholders as a whole, the court determined that "[c]orporate shareholders cannot in their own right and for their own personal use and benefit maintain an action for the recovery of corporate funds or property improperly diverted or appropriated by the corporation's officers and directors." 645 S.W.2d at 125. The court noted that "[w]here a complaint relates to the direct injury of the plaintiff, however, a derivative action may not be necessary." *Id.* Because the plaintiff failed to set forth facts showing how he had been individually harmed as a result of the improper stock transfer, the Missouri court concluded that he lacked standing to sue individually. *Id.*

We find *Dawson* inapposite to the facts in this case. Here, Grogan and Henson are not seeking redress for the misappropriation of corporate assets or property or for any wrong suffered by the corporation. Instead, they seek individual damages because Garner deceived them about the circumstances under which NACC acquired the STI enterprise. When this evidence is viewed in the light most favorable to the plaintiffs, as we are bound to do, there exists proof of misrepresentation by Garner that the

entire consideration to be paid was in exchange for STI-Missouri and assets of the wheel shop. Grogan and Henson allege additional evidence of fraud in Garner's failure to inform them of NACC's offer to buy separately the assets of the wheel shop, which was represented by Garner to be unfunded at that time, for an additional 2.5 million dollars. Grogan and Henson do not allege that Garner withheld assets of STI-Missouri; all the corporate assets of STI-Missouri, including STI-Kansas, were transferred for consideration to NACC when it acquired 100% of the STI stock. Neither do they challenge the overall consideration tendered in the stock transfer.<sup>7</sup>

Moreover, in *Gieselmann v. Stegemen*, 443 S.W.2d 127 (Mo. 1969), the Missouri Supreme Court held that in an action based upon a tort where an injury is done directly to a shareholder, the shareholder may bring suit on an individual basis and need not resort to a derivative action. *Gieselmann* involved six stockholders who brought

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<sup>7</sup> Had the plaintiffs challenged only the propriety of the pre-closing sale of STI-Kansas shares to certain employees of the corporation, then *Dawson* possibly would have been controlling because the plaintiffs would be challenging the sufficiency of consideration paid for STI-Kansas stock. Garner offered the stock to certain employees for one dollar per share plus an employment commitment. A few months earlier, before the NACC offer, Garner had offered the stock for \$40,000 for one percent of the company. However, the plaintiffs are not asserting a preemptive right to buy STI-Kansas stock; they are claiming that they were defrauded by Garner's representation that the consideration paid by NACC was in exchange for all the assets of the STI enterprise, including the wheel shop. The thrust of Garner's misrepresentation goes to the value of the plaintiffs' individual interests, or ten percent of STI-Missouri stock.

an individual suit against several other shareholders and the corporation. The plaintiffs claimed that they had been fraudulently deprived of controlling stock in the corporation and of positions on the board and as officers. As the court noted, not every allegation in the petition was appropriate for an individual action. However, "[t]he *gravamen* of the pleading \* \* \* [was] injury to the plaintiffs *as individuals*," 443 S.W.2d at 131 (emphasis in original), and the court allowed the individual suit to stand.<sup>8</sup>

There should be little question that the plaintiffs have standing to sue for their personal harm. The plaintiffs were asked to sell their stock for a stated price as represented in Garner's proposal of sale. Although the proposal concerned the sale of STI-Missouri, Garner made it clear that the shareholders should "fully understand what the offer would mean to you personally before making your decision to sell or not to sell." The shareholders were told that the consideration set forth was the

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<sup>8</sup> Grogan and Henson also rely on a recent Missouri Court of Appeals decision to bolster their standing argument. In *Forinash v. Daugherty*, 697 S.W.2d 294 (Mo. App. 1985), shareholders of a closely held bank corporation brought suit alleging that officers and directors secretly sold controlling stock interests at the expense and to the exclusion of minority shareholders. The primary issue in the case was whether Missouri holds controlling shareholders in a closely held corporation to a fiduciary duty to minority shareholders, and if so, whether that duty is heightened because of the nature of the corporation.

Garner argues, and we agree, that *Forinash* does not deal with the issue of when a derivative suit is required. In fact, the court never mentions whether the suit was brought as a derivative or individual action.

full price to be paid for the STI enterprise, including the "Assets of the wheel shop (Not funded at this time)." This was an overall representation that NACC was paying the consideration set forth for *all* of the assets, including the wheel shop, and that plaintiffs' shares were to be ten percent of the entire consideration paid. Grogan and Henson had every right to believe that their ten percent interest included the assets of STI-Kansas as well as those of STI-Missouri.

Grogan and Henson testified and we must assume the jury found that on October 21, 1978, they did not know that Garner had incorporated the wheel shop and, with a few hundred dollars, purchased shares in it soon to be worth over two million dollars. Grogan and Henson also did not know that Garner had selectively distributed part of these shares to his relatives and certain employees. At the time of the NACC offer to buy the shares of stock of STI-Missouri, as communicated to the shareholders by Garner, Grogan and Henson were led to believe that STI-Missouri still owned all the assets of STI-Kansas and relied on that understanding when they approved the sale of their STI-Missouri shares of stock. Such reliance was reasonable considering that Garner represented in his May, 1978, letter that STI-Missouri would "retain 20-30% of STI-Kansas" after STI-Missouri shareholders purchased percentages of STI-Kansas. Such reliance is also reasonable in light of the proposal of sale that listed the wheel shop as one of the "subsidiaries" of STI-Missouri.

No doubt, the plaintiffs could have brought a derivative action had they known all the facts at the October 21 meeting. However, this action does not turn solely on

Garner's misappropriation of wheel shop assets but on the direct fraud committed by him when he misrepresented the terms of NACC's offer. In short, Garner's fraudulent actions prevented the plaintiffs from realizing the true value of their shares and maximizing that value in the sale to NACC. Grogan and Henson were directly harmed by Garner's misrepresentations, and they properly brought suit as individuals so harmed.<sup>9</sup>

### Sufficiency of the Evidence

Garner next argues that Grogan and Henson failed to produce sufficient evidence to sustain the jury's verdict. Although the record contains conflicting versions of the various transactions, the jury obviously believed the plaintiffs' version of what happened. This court cannot disturb a jury verdict if there is substantial evidence, viewed in the light most favorable to the plaintiffs, to support the verdict. *United States v. Lewis*, 759 F.2d 1316, 1352 (8th Cir.), *cert. denied*, 106 S. Ct. 406 (1985).

As part of his argument, Garner contends that there was insufficient evidence to establish causation for the alleged damages because neither plaintiff was an

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<sup>9</sup> On effect of a successful attack on the plaintiffs' individual suit would have been to destroy complete diversity jurisdiction. However, had this occurred, the plaintiffs point out that the § 10(b) claim establishes federal question jurisdiction so that the counts of common law fraud and breach of fiduciary duty would still be within the district court's pendent jurisdiction. See *United Mine Workers v. Gibbs*, 383 U.S. 715, 725 (1966).

STI-Kansas shareholder. As we have already discussed, Garner miscomprehends the essence of the plaintiffs' claims. Grogan and Henson acknowledge that they were not STI-Kansas shareholders. They do not claim a right to be STI-Kansas shareholders, nor do they claim a preemptive right to buy STI-Kansas stock at one dollar per share. Their allegations are grounded in Garner's fraudulent misrepresentation of the terms of the sale to NACC. Because of these misrepresentations, neither plaintiff was aware of the true value of his STI-Missouri stock. See *Myzel v. Fields*, 386 F.2d 718, 733 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). This is especially significant not only in terms of dollar value, but also of bargaining power. NACC's offer was conditioned on 100% shareholder approval of the sale. Garner's fiduciary duties as a director and officer of STI-Missouri included the duty to disclose fully the terms of a sale affecting the plaintiffs' interests in STI-Missouri. We find substantial evidence, as did the jury, to support proof of fraud committed by Garner against the plaintiffs.

### Jury Instructions

Garner contends that the trial court committed various errors in its jury instructions. The trial court has broad discretion to instruct the jury in the form and language it considers a fair and adequate presentation of substantive law. *Garnes v. Gulf & Western Mfg. Co.*, 789 F.2d 637, 642 (8th Cir. 1986). This court reviews jury instructions to determine whether, taken as a whole, they are confusing or misleading in presenting the principles of law applicable to the case. *Des Moines Bd. of Waterworks*

*v. Alvord, Burdick & Howson*, 706 F.2d 820, 823 (8th Cir. 1983).

We believe that the instructions as a whole fairly and adequately presented the substantive law and were neither misleading nor confusing so as to prejudice the defendant. Garner challenges instructions 6, 7, 12, 23, 24, and 29, not because they misstated Missouri law, but because they resulted in "redundant overkill" when the court separately instructed on misrepresentation and nondisclosure. To simultaneously instruct the jury on both, however, would have required the court to discuss dissimilar legal elements in one instruction. We find the court's separate instructions more in keeping with the objective of facilitating the jury's understanding of the substantive law.

Garner also challenges instructions 8, 9, 25, and 26, which relate to Garner's breach of fiduciary duty. The instructions described Garner's fiduciary duties to the plaintiffs as well as to the corporation. As we have already explained, Garner had a fiduciary duty to disclose fully to the plaintiffs the terms of NACC's offer, including the provisions relating to the wheel shop. The jury was properly instructed that it could find Garner guilty of breach of fiduciary duty if he failed to disclose the complete terms of the offer.<sup>10</sup>

<sup>10</sup> Although Garner objected at trial to the fiduciary duty instructions, he did not offer an alternative instruction. A party may not complain on appeal that an instruction is ambiguous if he fails to offer a clearer instruction at trial. *Roth v. Black & Decker, U.S., Inc.*, 737 F.2d 779, 783 (8th Cir. 1984).

We also find the district court was within its discretion when it used the appropriate legal terms to differentiate the various theories in the case. Much of Garner's objection to the instructions focuses on their form. He claims that they were not set out under the systemized approach mandated by the Missouri Approved Jury Instructions. We have noted on other occasions, however, that while instructions pertaining to claims for relief under diversity jurisdiction must fully and properly instruct on all the elements of controlling state law, the form of state-approved jury instructions is not binding on the district court. *Ferren v. Richards Mfg. Co.*, 733 F.2d 526, 530 (8th Cir. 1984) (Missouri jury instructions).<sup>11</sup>

### Expert Testimony

Garner next contends that the district court erred when it refused to allow the expert testimony of Richard Sewell, an accountant. Garner claims that Sewell's testimony regarding the tax consequences in 1978 in selling both STI-Missouri and STI-Kansas in one transaction would have critically undermined the plaintiffs' case. Sewell was allowed to testify about various STI financial statements, but plaintiffs' counsel objected when Sewell

<sup>11</sup> Garner also claims error in the district court's failure to instruct on certain affirmative defenses. However, he has not preserved his right to appeal because he failed to timely object at trial. A party who tenders instructions but fails to object to the court's failure to give the proffered instructions waives the right to complain on appeal. *DeFranco v. Valley Forge Ins. Co.*, 754 F.2d 293, 296 (8th Cir. 1985).

was asked about the tax ramifications of the sale of a business entity similar to the STI enterprise.<sup>12</sup>

The court excluded Sewell's testimony because Garner had failed to reveal in answers to interrogatories that he planned to use this expert testimony. Plaintiffs' Interrogatory No. 11 inquired, pursuant to Fed. R. Civ. P. 26(b)(4)(A)(i), as to the identity of the defendant's expert witnesses and the subject of their testimony. Garner's answer to this interrogatory did not indicate that the tax consequences of the transaction was a subject area to be testified to by an expert. After examining the interrogatory answer and questioning counsel about it, the district court excluded Sewell's testimony regarding potential tax ramifications of the sale. Generally, an appellate court will reverse the district court's decision to exclude evidence only when there has been an abuse of discretion. See *SCNO Barge Lines, Inc. v. Anderson Clayton & Co.*, 745 F.2d 1188, 1192 (8th Cir. 1984). The trial court did not abuse its discretion when it refused to admit this evidence.

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<sup>12</sup> Counsel for Garner asked Sewell the following question:

Q. And December of 1978, if someone would have sold the same business entities for a total of \$2 million in cash, or \$2.5 million in cash and \$2.5 million worth of valued stock, of stock that supposedly had that value, would that whole transaction have been treated as a long-term capital gain or as some other transaction which would put it in a different tax rate? I don't want to know the rate. I just want to know the theory behind it.

## Damages, Prejudgment Interest, and Election of Remedies

Garner's final two claims of error relate to the damages awarded. Garner argues that the trial court erred in granting the plaintiffs' post-verdict motion for prejudgment interest on the § 10(b) claim and in not requiring the plaintiffs to elect the count under which they recovered their judgment. As we stated earlier, the jury originally awarded both Henson and Grogan \$249,000 on each of the three counts, plus \$24,900 punitive damages on the fraud count. The court adjusted the award so that each plaintiff received only one award of \$249,000 plus punitive damages and prejudgment interest.

Punitive damages are not permitted in a § 10(b) claim. *Nye v. Blyth Eastman & Dillon Co.*, 588 F.2d 1189, 1200 (8th Cir. 1978). At one time, federal courts struggled with the question of whether § 28(a), 15 U.S.C. § 78bb, of the Securities Exchange Act of 1934 prohibits an award of punitive damages in a pendent state claim, even if state law permits such damages.<sup>13</sup> The courts now appear to uphold uniformly punitive damages awarded under these circumstances. See, e.g., *Nye v. Blyth Eastman & Dillon*, *supra* at 1200; *Ryan v. Foster & Marshall, Inc.*, 556

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<sup>13</sup> Section 28(a) provides in part:

The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

F.2d 460, 464 (9th Cir. 1977); *Falks v. Koegel*, 504 F.2d 702, 706-07 (2d Cir. 1974); *Coffee v. Permian Corp.*, 474 F.2d 1040, 1044 (5th Cir.), *cert. denied*, 412 U.S. 920 (1973); *Young v. Taylor*, 466 F.2d 1329, 1337 (10th Cir. 1972).

While the case law, including that of this circuit, clearly allows for recovery of punitive damages in pendent state claims, we have not before been faced with whether punitive damages on a common law claim and prejudgment interest on a federal claim are both recoverable when the plaintiff has prevailed on both. Unlike punitive damages, prejudgment interest on a § 10(b) claim is permitted and is within the sound discretion of the trial court.<sup>14</sup> See *Blau v. Lehman*, 368 U.S. 403, 414 (1963); *Woods v. Barnett Bank*, 765 F.2d 1004, 1014 (11th Cir. 1985).<sup>15</sup>

<sup>14</sup> Garner also argues that prejudgment interest was improper because it was not pled and submitted to the jury. While there is analogous case law to this effect, see *Segal v. Gilbert Color Systems, Inc.*, 746 F.2d 78, 82 (1st Cir. 1984) (involving 28 U.S.C. § 1875, the Grand Jury Act); *Furtado v. Bishop*, 604 F.2d 80, 98 (1st Cir. 1979) (involving 42 U.S.C. § 1983), *cert. denied*, 444 U.S. 1035 (1980), it is clearly not the rule in this circuit in actions arising under the Securities Exchange Act of 1934. See *Western Auto Supply Co. v. Gamble-Skogmo Co.*, 348 F.2d 736, 744 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). An award of prejudgment interest in a § 10(b) case is within the sound discretion of the trial court and will be overturned only if it is so unfair or so inequitable as to require it. *Riseman v. Orian Research, Inc.*, 749 F.2d 915, 921 (1st Cir. 1984). The trial court did not abuse its discretion when it awarded prejudgment interest on the § 10(b) claim.

<sup>15</sup> Grogan and Henson did not cross-appeal the trial court's limiting the award of prejudgment interest to the

(Continued on following page)

Garner's argument that the plaintiffs may not recover duplicious damages is well taken, but we do not believe this requires an "election of remedies" in its traditional sense. Election of remedies is, in the words of one commentator, "the legal version of the idea that a plaintiff may not have his cake and eat it too." D. Dobbs, *Remedies* § 1.5 at 14 (1973). A plaintiff must elect among remedies when he has available inconsistent remedies for the redress of a single right. A plaintiff, for example, may sue for damages for the conversion of property or he may bring a replevin action to recover the property itself. See *Myzel v. Fields*, *supra* at 740-41. The doctrine and the cases interpreting it often "do no more than prevent double recovery," although the principle is not always clearly expressed or properly used. *Dobbs, supra*. However, the doctrine is remedial, and neither it nor the federal rules of pleading require an election of substantive theories. *Dobbs, supra* at 16; see also Fed. R. Civ. P. 8(a).

Grogan and Henson are not seeking inconsistent remedies requiring an election in the typical sense. They

(Continued from previous page)

§ 10(b) count. Prejudgment interest in a diversity action is determined by the law of the state where the action arose. *California & Hawaiian Sugar Co. v. Kansas City Terminal Warehouse*, 788 F.2d 1331, 1333 (8th Cir. 1986). In Missouri prejudgment interest is generally appropriate when the amount due is liquidated or, although not strictly liquidated, is readily ascertainable by reference to recognized standards. See *St. Joseph Light & Power Co. v. Zurick Ins. Co.*, 698 F.2d 1351, 1355 (8th Cir. 1983) (citing *Denton Constr. Co. v. Missouri State Highway Comm'n*, 454 S.W.2d 44, 59-60 (Mo. 1970)). Because the issue was not raised on appeal, we make no judgment as to the propriety of prejudgment interest on the common law counts.

did not ask for a rescission of the contract of sale to NACC along with money damages. Cf. *Randall v. Loftsgaarden*, 106 S. Ct. 3143, 3153 (1986) (plaintiff in § 10(b) case in some circumstances may choose between rescission and actual damages). They sought and were awarded money damages for the amount they considered their fair share of the overall consideration paid by NACC for the assets of STI-Missouri as represented by Garner.<sup>16</sup> They were also awarded punitive damages on the fraud count and prejudgment interest on the § 10(b) count.<sup>17</sup>

When a federal securities claim overlaps with a pendent state law claim, the plaintiff is entitled to the maximum amount recoverable under any claim. Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Geo. L.J. 1093, 1166 (1977). This does not require an election of remedies. Instead, Grogan and Henson are each entitled to the greatest amount recoverable under any single theory pled, with actual damages plus prejudgment interest representing one single amount and actual damages plus punitive damages representing the other single amount. *Randall v. Loftsgaarden*, 106 S. Ct. at 3156 (Blackmun, J., concurring) (parties who prevailed on § 10(b) claim and on § 12(2) claim entitled to select the damage amount more favorable to them); *Aboussie v. Aboussie*, 441 F.2d

<sup>16</sup> Each plaintiff was awarded \$249,000 in actual damages, or approximately 10% of the 2.5 million dollars paid for STI-Kansas.

<sup>17</sup> Each plaintiff was awarded \$24,900 in punitive damages, or 10% of the actual damages. The court awarded prejudgment interest at nine percent per annum from April 17, 1979, to the date of judgment.

150, 157 (5th Cir. 1971) (jury award under common law count upheld; new trial ordered to determine damages under 10b-5, with caveat that if federal damages are less than common law damages, the federal damages are extinguished); cf. *McDonald v. Johnson & Johnson*, 776 F.2d 767, 770 (8th Cir. 1985) (fraud and contract claims constitute separate causes of action because defendant's illegal acts occurred at separate and distinct times; therefore, plaintiffs' collection of contract judgment does not preclude litigation of fraud claim). We therefore conclude that Grogan and Henson may receive one award of damages under either the § 10(b) claim or the common law claim, whichever is the greatest, and upon satisfaction of the judgment, the lesser damages are deemed extinguished.

The judgment in favor of Grogan and Henson is affirmed as to liability; the judgment for damages is modified in accord with the principles set forth herein.

A true copy.

ATTEST:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

UNITED STATES COURT OF APPEALS  
For The Eighth Circuit

U.S. Court & Custom House  
1114 Market Street  
St. Louis, Missouri 63101

Robert D. St. Vrain  
Clerk

314-425-5600  
FTS: 279-5600

December 8, 1986

Mr. Arthur Stoup  
950 Home Savings Bldg.  
1006 Grand Ave.  
Kansas City, MO 64106

Messrs.  
Thomas M. Franklin and  
Michael J. Gallagher  
127 W. 10th St., Ste. 1015  
Kansas City, MO 64105

Re: 85-2098WM Coy R. Grogan, et al. v. Frank J. Garner, Jr.

Dear Counsel:

Enclosed is a copy of the opinion filed today in the referenced case. Judgment in accordance with the opinion is also entered today.

Please review Federal Rules of Appellate Procedure 35 and 40 and Eighth Circuit Rules 15 and 16. Petitions for rehearing *must* be received by the Clerk's office within the time set by FRAP 40 (within 14 days of entry of judgment) unless extended by court order. Petitions for rehearing or motions to extend the time for filing rehearing requests are not afforded any grace period for mailing and are subject to being denied if not timely received. Please review Eighth Circuit Rule 16(d) if an en banc request is contemplated.

You are also directed to Federal Rule of Appellate Procedure 39 and Eighth Circuit Rules 7(f) and 8(j). Itemized and verified bills of costs are to be filed with this office with proof of service **within 14 days from this date**. Counsel for the prevailing party should **promptly** forward to us an itemized bill of costs for the reproduction of the authorized number of copies of their briefs. Failure to submit an itemized bill of costs will result in waiver of costs. Untimely itemized bills of costs will not

be processed without a special order of the Court. Objections to requested bills of costs must also be submitted on a timely basis-within 10 days of the bill of costs.

Sincerely,

ROBERT ST. VRAIN, CLERK

BY: /s/ Jackie Peters  
Jackie Peters  
Deputy Clerk

RSV/jp  
Enclosure

cc: Robert F. Connor, Clerk, 84-516-CV-W-5

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IN THE UNITED STATES BANKRUPTCY COURT  
WESTERN DISTRICT OF MISSOURI

Case No. 85-03755-2

Adv. No. 86-0183-2

(Caption Omitted In Printing)

ORDER DENYING MOTION TO ALTER OR  
AMEND JUDGMENT

(Filed Mar. 20, 1987)

Defendant has filed his Motion to Alter or Amend Judgment. The Court has considered and reconsidered the basic semantic question, i.e., does the term 'clear and convincing mean something more than 'preponderance [sic] of' or 'sufficiency of' when modifying the word 'evidence'?' Right or wrong, this Court has concluded that in the context of Section 523, it does not.

Counsel for debtor in effect argue that there are three standards of evidence. First, "beyond a reasonable doubt", the sine qua non of the criminal finding. Second, "preponderance of the evidence" which sometimes has even been called "the weight of the evidence", the usual standard for civil finding. Third, "clear and convincing" which would apparently reside somewhere between the two standards set out above. Unfortunately, this Court can find no clear and convincing reason to conclude that this evidentiary halfway house is real rather than illusory. Instead it seems to be an endless circle merely using different words for the same standard.

The Court, therefore, OVERRULES defendant's Motion on the basis of a conclusion of law that "clear and convincing evidence" is not a higher standard of evidence than "preponderance of evidence".

SO ORDERED this 20 day of March, 1987.

/s/ Frank W. Koger  
BANKRUPTCY JUDGE

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IN THE UNITED STATES BANKRUPTCY COURT  
WESTERN DISTRICT OF MISSOURI

Case No. 85-03755-2

Adv. No. 86-0183-2

(Caption Omitted In Printing)

AMENDED MEMORANDUM OPINION AND ORDER

(Filed Jun 17, 1987)

This adversary action by two creditors seeking to avoid discharge of debtor on their respective claims came to an abrupt halt at the conclusion of creditors' case when debtor elected to present no evidence and stood on his oral Motion for Dismissal made when the plaintiff/creditors rested. Creditors had each obtained a jury verdict against debtor in the United States District Court for the Western District of Missouri, before the petition for reorganization was filed. Debtor had appealed the resulting judgments to the Eighth Circuit Court of Appeals. That latter tribunal affirmed the judgments post petition and this § 523 Adversary proceeding, having been timely filed, proceeded to trial. Creditors did not offer the transcript of the proceedings in the District Court case. Instead, they introduced only four exhibits and rested.

Those four exhibits were:

- Exhibit 1: A copy of creditors' first amended complaint.
- Exhibit 2: A copy of debtor's addendum to the brief of debtor to the Eighth Circuit, containing instructions to the jury and the Verdict Director as well as the jury verdict and the District Court judgment.
- Exhibit 3: The opinion of the Eighth Circuit Court of Appeals.

Exhibit 4: Letter from Eighth Circuit Court of Appeals transmitting the opinion.

The Court, therefore, is required to determine from the exhibits if creditors have made a case and established all elements necessary under § 523.

The original District Court complaint is drawn in five counts. Count I alleged common law fraud, potentially cognizable under § 523(a)(2). Count II alleged a breach of fiduciary duty, potentially cognizable under § 523(a)(4). Count III alleged a use of interstate [sic] instrumentality to make alleged misrepresentations. This Court [sic] adds nothing in a bankruptcy proceeding under § 523. Count IV alleged a RICO violation which again, adds nothing to a bankruptcy proceeding under § 523. For the reasons stated hereafter, the Court will consider only Count I or the common law fraud Count.

The jury instructions in Count I required the jury to find in Instruction Number 6 and Instruction Number 23 (respectively to each creditor):

- First: That debtor made a representation to each creditor.
- Second: That the representation was false.
- Third: That the defendant knew his representation was false.
- Fourth: That the representation was material in causing each creditor's decision.
- Fifth: That each creditor relied on the debtor's representation.

Sixth: That as a direct result of such representation each creditor was damaged.

Seventh: That each creditor did not discover the alleged fraud until a later date.

The jury verdict was unanimous in favor of each creditor and against the debtor on Count I, as well as two other counts. After the filing of post trial motions, the District Court ruled:

"Here there clearly was sufficient evidence to support the jury's conclusion that defendant . . . intentionally defrauded plaintiffs."

The United States Court of Appeals for the Eighth Circuit unaimously [sic] affirmed and held that there was sufficient evidence to support the verdict.

Since 1970, the bankruptcy courts have been the sole arbiter of what debts are not discharged by a bankruptcy proceeding. *Brown v. Felsen* 442 U.S. 127, 99 S.Ct. 2205 (1979) tells us that: " . . . are the type of questions that Congress intended the bankruptcy court would resolve," (1.c. 2112). Although that opinion dealt only with a state court judgment, there is no reason to suspect that the same rule would not apply to judgments rendered in Federal Courts also. The question then becomes did the judgment in the District Court constitute so similar a finding of fraud in that action as to provide a basis for the bankruptcy court to determine that § 523 fraud was committed thereby rendering the judgment non dischargeable, or is the debtor collaterally estopped from relitigating those issues of fact determined by a prior finding thereon. Again, *Brown v. Felsen* Id. footnote 10,

page 2213, supplies the answer. "If in the course of adjudicating a state-law question, a state court should determine factual issues using standards identical to those of Section 17, then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court." Thus, the Court is led to the conclusion that the elements to be provided under § 523(a)(2) must be compared with the elements decided by the unanimous jury in the District Court case, and, if identical, as to content and standard, creditors have borne their burden.

Under Section 523(a)(2) those elements are:

- (1) Utterance or issuance of a representation,
- (2) Proof of the falsity of the representation,
- (3) Proof of knowledge on the part of the maker of that falsity,
- (4) Intent to mislead or deceive the alleged victim by the maker,
- (5) Reliance on the representation of the victim,
- (6) Proof that damage occurred to the alleged victim.

(See *Sweet v. Ritter Finance Company*, 263 F.Supp. 540 (W.D. Va. 1967).

By comparing these standards with instructions Number 6 and Number 23, it appears to the Court that every element required to be found by the Court in the dischargeability hearing was already found by the jury in the District Court verdict. Further those findings received the judicial seal of approval from the District Court in its

Order of August 7, 1986, when it stated: "Here, there clearly was sufficient evidence to support the jury's conclusion that defendant violated his fiduciary duty and intentionally defrauded plaintiffs." The Court of Appeals, Eighth Circuit, stated: "We find substantial evidence, as did the jury, to support proof of fraud committed by Garner against the plaintiffs."

Therefore although this Court believes and holds that the Bankruptcy Court is the sole arbiter of § 523 dischargeability vel non, nevertheless where identical factual issues have been fully litigated and properly decided using identical standards by courts of appropriate jurisdiction, collateral estoppel bars relitigation of those issues in this Court. This leads to the final question to be determined by this Court, i.e., were identical standards used?

In defendant's brief, the point is made that the standard in the District Court trial was "preponderance of the evidence" while the standard should be "clear and convincing" and that the two are totally dissimilar. If defendant's point is well taken, then obviously collateral estoppel does not come into play and there is insufficient evidence before the Court to determine dischargeability. The Honorable Dennis J. Stewart, Chief Bankruptcy Judge of this District, had occasion to explore this identical question in a footnote to his opinion in *Matter of Curl*, 49 B.R. 302 (Bkr. W.D. Mo. 1985), see footnote 6. This Court, although not bound by that ruling, frankly considers it not only the best exposition of how the apparent divergence arose, but strongly recommends that any counsel engaged in § 523 litigation regard that opinion (and the

footnotes) as required reading for a thorough understanding of the elements of proof and the applicability of evidentiary standards. Accordingly, this Court concludes that there is no real distinction between "preponderance of the evidence" and "clear and convincing" as regards § 523 litigation.

Inexorably then, the Court concludes that through collateral estoppel, creditors sustained the burden of proof and through their exhibits sustained the burden as to all elements of dischargeability. The judgment rendered on common law fraud which was pled in Count I of plaintiff's original complaint in Federal District Court is, therefore, ruled to be non-dischargeable. No ruling is necessary on any other Count, even Count II, the alleged fiduciary breach, inasmuch as only one recovery may be had by creditors. Although this result is in favor of creditors, the Court must point out that it believes better practice [sic] would be to introduce the transcript in such a proceeding, and that creditors in similar proceedings run a substantial risk of not presenting the Court with sufficient evidence upon which to base a ruling when they rely upon collateral estoppel alone.

SO ORDERED this 17 day of June, 1987.

/s/ Frank W. Koger  
BANKRUPTCY JUDGE

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## JUDGMENT IN A CIVIL CASE

(Filed Feb 29, 1988)

United States District  
CourtDistrict  
WESTERN DISTRICT OF  
MISSOURI

Case Title

John R. Henson and  
Coy R. Grogan  
V.

Docket Number

87-0434-CV-W-1

Frank J. Garner, Jr.

Name of Judge or  
Magistrate

Judge Dean Whipple

[ ] **Jury Verdict.** This action came before the Court and a jury with the judicial officer named above presiding. The issues have been tried and the jury has rendered its verdict.

[X] **Decision by Court.** This action came to trial or hearing before the Court with the judge (magistrate) named above presiding. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

that the court therefore adopts the findings of the Bankruptcy Court and incorporates them in these findings by reference, and affirms the decision of the Bankruptcy Court.

Entered on Mar 1 1988

Clerk

Robert F. Connor

Date

Feb. 29, 1988

(By) Deputy Clerk

/s/ Leonora S. Miller

ORIGINAL

IN THE UNITED STATES DISTRICT COURT FOR THE  
WESTERN DISTRICT OF MISSOURI  
WESTERN DIVISION

No. 87-0434-CV-W-1

(Caption Omitted In Printing)

**ORDER**

(Filed May 19, 1988)

Before the court is appellant's motion to alter or amend judgment, dated February 29, 1988, filed March 11, 1988. Appellees filed suggestions in opposition on April 5, 1988.

Appellant requests this court to alter or amend its February 29, 1988 judgment upon the ground that there is an actual distinction between the standard of proof required in an 11 U.S.C. § 523(a)(2)(a) action and a common law fraud action. Thus, appellant argues this court should enter judgment in favor of appellant. In their suggestions in opposition, appellees point out that appellant has raised no new legal arguments in his latest brief. Further, appellant does not dispute that the bankruptcy dischargeability adversary proceeding and the common law fraud case involved identical factual issues. Appellant merely continues to assert that the district court judgment was not based upon the identical burden of proof as that required in § 523 litigation.

Appellant again asserts that the recent Eighth Circuit decision in *In re Van Horne*, 823 F.2d 1285 (8th Cir. 1987) somehow sheds new light on the burden of proof required in § 573[sic](a)(2)(A) dischargeability actions. This argument was addressed in the court's February 29, 1988 order. Accordingly, appellant's motion to alter or

amend this court's judgment dated February 29, 1988 is denied.

/s/ Dean Whipple  
DEAN WHIPPLE

UNITED STATES DISTRICT  
JUDGE

DATED: MAY 19TH, 1988.

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IN THE UNITED STATES DISTRICT COURT  
FOR THE WESTERN DISTRICT OF MISSOURI  
WESTERN DIVISION

Case No. 87-434-CV-W-1

(Caption Omitted In Printing)

NOTICE OF APPEAL

(Filed June 17, 1988)

FRANK J. GARNER, JR., the Debtor/Defendant, appearing in his own behalf without legal counsel, appeals to the Eighth Circuit Court, from the Order of the District Court denying Defendant's Dischargability [sic] of Judgment entered on the 29th day of February, 1988; and, Order denying Defendant's Motion to Alter or Amend Judgment of the District Court entered in this proceeding on the 19th day of May, 1988.

The parties to the Orders appealed from and the names and addresses of their respective attorneys are as follows:

Frank J. Garner, Jr.,  
Defendant  
2510 Grand Avenue  
Unit 1901  
Kansas City, MO 64108  
DEBTOR/DEFENDANT

John R. Henson and  
Coy R. Grogan, Plaintiffs  
Michael J. Gallagher  
4435 Main, Suite 840  
Kansas City, MO 64105  
ATTORNEY FOR PLAINTIFFS

DATED: June 17, 1988

(Signature Block Omitted In Printing)

UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF MISSOURI

No. 84-0516-CV-W-5  
Kansas City, Missouri  
April 23, 1985

(Caption Omitted In Printing)

PARTIAL TRANSCRIPT OF JURY TRIAL  
BEFORE THE HONORABLE SCOTT O. WRIGHT  
UNITED STATES DISTRICT JUDGE

(Filed July 14, 1989)

(p. 2)

\* \* \*

THE COURT: All right. Now, ladies and gentlemen of the jury, I'll read you these instructions. This instruction and other instructions are for your guidance in your deliberations when you retire to the jury room. They will directly concern the legal rights and duties of the parties, and how the law applies to the facts which you will be called upon to decide. The trial may begin with opening statements by the lawyers as to what they expect the evidence to be. At the close of the evidence, the lawyers may make arguments on behalf of their clients. Neither what is said in opening statements or closing arguments is to be considered as proof of a fact. However, if a lawyer admits some fact, on behalf of his client, the other party is relieved of the responsibility of proving that fact. After the opening statements, the plaintiff will introduce evidence. After that, the defendant may introduce evidence and there may be rebuttal evidence after that. The evidence may include the testimony of witnesses who appear personally in court, the testimony of witnesses who may not appear personally, but whose testimony

may be read to you in exhibits, such as pictures, documents, and other objects. While the trial is in progress, I may be called upon to determine questions of law and to decide whether these matters may be considered by you under the law. No ruling or remark which I may make at any time during the (p. 3) trial will be intended or should be considered by you to indicate my opinion as to the facts. There may be times when the lawyers come up to talk to me out of your hearing. This will be done in order to permit me to decide questions of law. These conversations will be out of your hearing to prevent issues of law, which I must decide, from become mixed with issues of fact, which you must decide. We will not be trying to keep secrets from you. After all the evidence has been presented and you've heard the closing arguments of the lawyers and received my instructions, you will retire to the jury room for your deliberations. At that time, it will be your duty to select a foreman, to decide the facts and to arrive at a verdict. Justice requires that you not make up your mind about the case until all the evidence had been seen and heard. You must not comment on or discuss what you may hear or learn in the trial until the case is concluded and you retire to the jury room for your deliberations. During the trial, you should not remain in the presence of anyone who is discussing the case when the court is not in session. Otherwise, some outside influence or comment might influence a juror to make up his or her mind prematurely and be the cause of a possible injustice. For this reason, the lawyers and their clients are not permitted to talk with you until the trial is completed. When you enter into your deliberations, you will be considering the testimony of witnesses, as well as (p. 4)

other evidence to which I've referred. In considering the weight and value of the testimony of any witness, you may take into consideration the appearance, attitude, and behavior of the witness, the interest of the witness in the outcome of the case, the relation of the witness to any of the parties, the inclination of the witness to speak truthfully or untruthfully, and the probability or improbability of the witness's statements. You may give the testimony of any witness such weight and value as you believe that testimony is entitled to receive. There'll be some matters which will be offered by the parties and to which objections will be made. If I overrule the objection, you may consider that matter when you deliberate on the case. If I sustain an objection, then that matter and any matter I order to be stricken is excluded and must not be considered by you in your deliberation. Again in the trial, you must make your decision based on what you recall of the evidence. You'll not have a written transcript to consult, and the court reporter cannot read back lengthy testimony. You must pay close attention to the testimony as it is given. Finally, to insure fairness, you as jurors must obey the following rules. First, do not talk among yourselves about this case or about anyone involved with it until the end of the case when you go to the jury room to decide on your verdict. Second, do not talk to anyone else about this case or about anyone involved with it until the trial has ended and (p. 5) you have been discharged as jurors. Anyone else includes members of your family and friends. You may tell them that you're a juror in a federal civil case, but don't tell them anything else about it until after you've returned your verdict. Third, when you're outside the courtroom do not let anyone tell you anything

about the case or about anyone involved in it. If someone should try to talk to you about the case, please report it to me immediately. Fourth, you should not talk with or speak to any of the parties, lawyers, or witnesses involved in this case. You should not even pass the time of day with any of them. It is important not only that you do justice in this case, but that you also give the appearance of doing justice. If a person from one side of the lawsuit sees you talking to a person from the other side, even if it's simply to pass the time of day, an unwarranted or unnecessary suspicion about your fairness may be aroused. If any lawyer, party, or witness does not speak to you when you pass in the hall, ride the elevator, or the like, please keep in mind that I've instructed them to avoid talking or visiting with you. Fifth, do not read any news stories or articles about the case or about anyone involved in it, or listen to any radio or television reports about the case or about anyone involved with it. In fact, until the trial's over, I'd suggest that you avoid reading any newspapers or news journals at all, and avoid listening to any TV or radio newscasts at (p. 6) all. I do not know if there might be any news reports of this case, but if there are you might inadvertently find yourself reading or listening to something before you could do anything about it. If you want, you can have your spouse or a friend clip out any stories, set them aside to give you after the trial is over. I can assure you, however, that by the time you've heard the evidence in this case you will know more about the matter than anyone will learn through the news media. Sixth, do not do any research and make any investigation about the case on your own. Seven, do not make up your mind during the trial about

what the verdict should be. Keep an open mind until after you've gone to the jury room to decide the case, and you and your fellow jurors have discussed the evidence. Now that I've given you my preliminary instructions, the remainder of the trial will proceed in the following manner. First, the plaintiff's attorney will make an opening statement, which is simply an outline to help you understand what the plaintiff expects to prove. Next, the defendant's attorney may, but does not have to, make an opening statement. The Plaintiff will then present his evidence and counsel of defendant may cross examine. Following the Government's case, the defendant may present evidence and the plaintiff may cross examine. After presentation of evidence is completed, the attorneys will make their closing arguments to summarize and interpret the evidence for you. Also, I (p. 7) shall instruct you further on the law. After that, you will retire to deliberate on your verdict.

(END OF REQUESTED PROCEEDINGS)

\* \* \*

I CERTIFY THAT THE FOREGOING IS A CORRECT TRANSCRIPT OF THE RECORD OF PROCEEDINGS IN THE ABOVE ENTITLED MATTER.

/s/ Deanna J. Miller July 13, 1989  
DEANNA J. MILLER

---

Instruction No. 1

As you remember, the Court gave you a general instruction before the presentation of any evidence in this

case. The Court will not repeat that instruction at this time. However, that instruction and the additional instructions, to be given to you now, constitute the law of this case and each such instruction is equally binding upon you. You should consider each instruction in light of and in harmony with the other instructions, and you should apply the instructions as a whole to the evidence. The order in which the instructions are given is no indication of their relative importance. All of the instructions are in writing and will be available to you in the jury room.

Given  
(Filed May 1, 1985)

---

Instruction No. 2

In returning your verdict you will form beliefs as to the facts. The court does not mean to assume as true any fact referred to in these instructions but leaves it to you to determine what the facts are.

---

Instruction No. 3

In these instructions, you are told that your verdict depends on whether or not you believe certain propositions of fact submitted to you. The burden of causing you to believe a proposition of fact is upon the party whose claim or defense depends upon that proposition. In determining whether or not you believe any such proposition,

you must consider only the evidence and the reasonable inferences derived from the evidence. If the evidence in the case does not cause you to believe a particular proposition submitted, then you cannot return a verdict requiring belief of that proposition.

---

Instruction No. 4

Your verdict must represent the considered judgment of each juror. In order to return a verdict, it is necessary that each juror agree. Your verdict must be unanimous.

It is your duty, as jurors, to consult with one another, and to deliberate with a view to reaching an agreement, if you can do so without violence to individual judgment. You must each decide the case for your self, but only after the impartial consideration of the evidence in the case with your fellow jurors. In the course of deliberations, do not hesitate to reexamine your own views, and change your opinion, if convinced it is erroneous. But do not surrender your honest conviction as to the weight or effect of evidence, solely because of the opinion of your fellow jurors, or for the mere purpose of returning a verdict.

Remember at all times that you are not partisans. You are judges – judges of the facts. Your sole interest is to seek the truth from the evidence in the case.

---

## INSTRUCTION NUMBER 5

Instruction 5 through 21 and general instructions 1 through 4 apply to the claims of the plaintiff Grogan against the defendant Frank J. Garner, Jr. use Verdict A to return your verdict on these claims.

## INSTRUCTION NUMBER 14

Section 1962(c) of RICO provides that it is unlawful for a person employed by or associated with an "enterprise" engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate directly or indirectly in the conduct of such enterprise's affairs through a pattern of racketeering.

## INSTRUCTION NUMBER 15

Your verdict must be for the plaintiff Grogan on his claim for violation of civil RICO if you believe:

First: That the Wheel Shop was an "enterprise," as that term is defined in Instruction 18; and

Second: That defendant on at least two occasions committed acts of mail or wire fraud; and

Third: That such acts of mail or wire fraud were connected by some common scheme, plan, or motive; and

Fourth: That defendant committed or caused to be committed those two or more acts of mail or wire

fraud while conducting and participating, either directly or indirectly, in the conduct of the affairs of the Wheel Shop; and

Fifth: As a direct result of the defendant's conduct as submitted in this instruction, plaintiff Grogan sustained damages.

Unless you believe plaintiff is not entitled to recover by reason of Instruction Number 19.

## INSTRUCTION NUMBER 16

Mail fraud, as referred to in Instruction No. 15, has five essential elements, which are:

First, the defendant made up a plan or scheme to obtain money or property by false statements or representations, and

Second, in furtherance of said plan or scheme, the defendant made certain false statements or representations and, at the time of making such false statements or representations, he knew that they were false, and

Third, that the false statements or representations related to something important to the plan or scheme, and

Fourth, that for the purpose of carrying out such plan or scheme, that the defendant used the mails; and

Fifth, that the defendant acted with the intention of obtaining money or property by false statements or representations.

## INSTRUCTION NUMBER 17

Wire fraud, as referred to in Instruction 15, has five essential elements, which are:

First, the defendant made up a plan or scheme to obtain money or property by false statements or representations, and

Second, in furtherance of said plan or scheme, the defendant made certain false statements or representations and, at the time of making such false statements or representations, he knew that they were false, and

Third, That the false statements or representations related to something important to the plan or scheme, and

Fourth, that, for the purpose of carrying out such plan or scheme, the defendant placed an interstate telephone call, and

Fifth, that the defendant acted with the intention of obtaining money or property by false statements or representations.

## INSTRUCTION NO. 18

The term "enterprise", as referred to in Instruction No. 15, is defined as any partnership, corporation, association, or other legal entity, or any group of individuals associated in fact although not a legal entity. An "enterprise" must exhibit three basic characteristics:

- (1) it must have a common or shared purpose;
- (2) it must have some continuity of structure and personnel; and
- (3) it must have an ascertainable structure distinct from that inherent in the conduct of the two or more acts of mail or wire fraud you may find under Instruction Number 15.

## INSTRUCTION NUMBER 19

Your verdict must be for the defendant on plaintiff Grogan's claim of violation of civil RICO if you believe plaintiff Grogan actually discovered, or, in the exercise of reasonable diligence, should have discovered the alleged acts in violation of RICO before May 7, 1982.

## INSTRUCTION NUMBER 22

Instruction 22 through 38 and general instruction 1 through 4th apply to the claims of the plaintiff Henson against the defendant Frank J. Garner, Jr. use Verdict B to return your verdict on these claims.

## INSTRUCTION NUMBER 31

Section 1962(c) of RICO provides that it is unlawful for a person employed by or associated with an "enterprise" engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate directly or indirectly in the conduct of such enterprise's affairs through a pattern of racketeering.

## INSTRUCTION NUMBER 32

Your verdict must be for the plaintiff Henson on his claim for violation of civil RICO if you believe:

First: That the Wheel Shop was an "enterprise," as that term is defined in Instruction 35; and

Second: That defendant on at least two occasions committed acts of mail or wire fraud; and

Third: That such acts of mail or wire fraud were connected by some common scheme, plan, or motive; and

Fourth: That defendant committed or caused to be committed those two or more acts of mail or wire fraud while conducting and participating, either directly or indirectly, in the conduct of the affairs of the Wheel Shop; and

Fifth: As a direct result of the defendant's conduct as submitted in this instruction, plaintiff Henson sustained damages.

Unless you believe plaintiff is not entitled to recover by reason of Instruction Number 36.

## INSTRUCTION NUMBER 33

Wire fraud, as referred to in Instruction 32, has five essential elements, which are:

First, the defendant made up a plan or scheme to obtain money or property by false statements or representations, and

Second, in furtherance of said plan or scheme, the defendant made certain false statements or representations and, at the time of making such false statements or representations, he knew that they were false, and

Third, that the false statements or representations related to something important to the plan or scheme, and

Fourth, that, for the purpose of carrying out such plan or scheme, the defendant placed an interstate telephone call, and

Fifth, that the defendant acted with the intention of obtaining money or property by false statements or representations.

## INSTRUCTION NUMBER 34

Mail fraud, as referred to in Instruction No. 32, has five essential elements, which are:

First, the defendant made up a plan or scheme to obtain money or property by false statements or representations, and

Second, in furtherance of said plan or scheme, the defendant made certain false statements or representations and, at the time of making such false statements or representations, he knew that they were false, and

Third, that the false statements or representations related to something important to the plan or scheme, and

Fourth, that, for the purpose of carrying out such plan or scheme, the defendant used the mails; and

Fifth, that the defendant acted with the intention of obtaining money or property by false statements or representations.

## INSTRUCTION NO. 35

The term "enterprise", as referred to in Instruction No. 32, is defined as any partnership, corporation, association, or other legal entity, or any group of individuals

associated in fact although not a legal entity. An "enterprise" must exhibit three basic characteristics:

- (1) it must have a common or shared purpose;
- (2) it must have some continuity of structure and personnel; and
- (3) it must have an ascertainable structure distinct from that inherent in the conduct of the two or more acts of mail or wire fraud you may find under Instruction Number 32.

## INSTRUCTION NUMBER 36

Your verdict must be for the defendant on plaintiff Henson's claim of violation of civil RICO if you believe plaintiff Henson actually discovered, or, in the exercise of reasonable diligence, should have discovered the alleged acts in violation of RICO before May 7, 1982.

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UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

JUDGMENT

No. 88-1991WM

87-434-CV-W-1

Appeal from the United States  
District Court for the  
Western District of Missouri  
(Caption Omitted In Printing)

(Filed Sep. 29, 1989)

This appeal from the United States District Court was submitted on the record of the district court and briefs of the parties without oral argument.

After consideration, it is hereby ordered and adjudged that the decision of the district court is reversed in accordance with the opinion of this Court.

August 9, 1989

A true copy.

Attest:     /s/ Robert D. St. Vrain

CLERK, U.S. COURT OF APPEAL, EIGHTH CIRCUIT

MANDATE ISSUED, September 25, 1989

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(5)

No. 89-1149

Supreme Court, U.S.  
FILED

JUL 3 1990

JOSEPH F. SPANIOL, JR.  
CLERK

In The  
**Supreme Court of the United States**  
October Term, 1989

COY R. GROGAN AND JOHN H. HENSON,  
*Petitioners,*

v.

FRANK J. GARNER, JR.,  
*Respondent.*

On Writ of Certiorari to the United States  
Court of Appeals for the Eighth Circuit

**BRIEF FOR THE PETITIONERS**

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**QUESTION PRESENTED**

1. Must exceptions to discharge under Bankruptcy Code § 523(a) be proven by the "preponderance of the evidence" standard or by the "clear and convincing evidence" standard?

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No. 89-1149

In The  
**Supreme Court of the United States**

October Term, 1989

COY R. GROGAN AND JOHN H. HENSON,

*Petitioners,*

v.

FRANK J. GARNER, JR.,

*Respondent.*

On Writ of Certiorari to the United States  
Court of Appeals for the Eighth Circuit

**BRIEF FOR THE PETITIONERS****OPINIONS BELOW**

The opinion of the Court of Appeals, App. to Pet. for Cert. 1a-15a, is reported at 881 F.2d 579. The opinion of the district court, App. to Pet. for Cert. 16a-29a, has not been reported. The opinion of the bankruptcy court, App. to Pet. for Cert. 30a-41a, is reported at 73 B.R. 26.

## JURISDICTION

The judgment of the Court of Appeals, App. to Pet. for Cert. 1a-15a, was entered on August 9, 1989, and a petition for rehearing was denied on September 12, 1989. App. to Pet. for Cert. 42a. A petition for a writ of certiorari was filed on December 11, 1989. J.A. 2. The petition was granted on April 30, 1990. *Id.* The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

---

## STATUTE INVOLVED IN THE CASE

Bankruptcy Code § 523(a)(2)(A) provides:

§ 523. Exceptions to discharge.

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt —

(2) for money, property, services, or an extension, renewal or refinancing of credit, to the extent obtained by —

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition[.]

(The entire text of § 523(a) appears in the Appendix to the Petition for Writ of Certiorari 43a-54a.)

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## STATEMENT OF THE CASE

Petitioners originally brought suit against respondent Frank J. Garner, Jr., in the United States District Court for the Western District of Missouri. App. to Pet. for Cert. 3a. In that action a jury determined that respondent had: (1) committed common law fraud under Missouri law; (2) breached the fiduciary duty he owed to petitioners; and (3) violated section 10(b) of the Securities and Exchange Act of 1934. *Id.*

On May 8, 1985, the jury awarded actual damages on the above three counts and punitive damages on the fraud count. The Eighth Circuit Court of Appeals affirmed the jury's verdict. *Grogan v. Garner*, 806 F.2d 829 (8th Cir. 1986). *Id.*

On October 21, 1985, respondent filed a Petition for Relief under the Bankruptcy Code and requested that petitioners' judgment against him be discharged. App. to Pet. for Cert. 3a. On May 7, 1986, petitioners filed an adversary proceeding in bankruptcy court seeking a determination that respondent's debt based on the common law fraud judgment was nondischargeable under 11 U.S.C. § 523(a). *Id.* at 3a-4a.

Petitioners relied on the doctrine of collateral estoppel which precludes the relitigation of issues concluded in the common law fraud trial to support their claim that the fraud debt was nondischargeable. At the § 523 hearing the bankruptcy court admitted into evidence the following documents:

1. A copy of petitioners' First Amended Complaint filed in the common law fraud action;

2. A copy of respondent's Addendum to his Brief to the Eighth Circuit, containing several of the jury instructions, Orders entered by the district court, the verdict directing instructions, the verdict and the district court judgment;

3. The opinion of the Eighth Circuit Court of Appeals; and,

4. A letter from the Eighth Circuit Court of Appeals transmitting the opinion.

App. to Pet. for Cert. 31a-32a.

Respondent presented evidence by his testimony, denying that he had committed fraud. *Id.* at 4a.

Relying on *Brown v. Felsen*, 442 U.S. 127 (1979), the bankruptcy court concluded that "the elements to be proved under Section 523(a)(2) must be compared with the elements decided by the unanimous jury in the District Court case, and, if identical, as to content and standard, [petitioners] have borne their burden." *Id.* at 36a. The bankruptcy court found that the elements were identical. *Id.* at 37a. The bankruptcy court also addressed respondent's contention that the "preponderance of the evidence" standard applied as petitioners' burden of proof in the common law fraud case was dissimilar from the "clear and convincing evidence" standard of § 523 proceedings. Respondent argued this difference should preclude the use of collateral estoppel in nondischargeability proceedings. *Id.* at 39a. The bankruptcy court rejected respondent's contention, concluding that "there is no real distinction between 'preponderance of the evidence' and 'clear and convincing evidence' as regards Section 523 litigation." App. to Pet. for Cert. 40a.

The bankruptcy court ruled that the issue of respondent's fraud had been litigated fully, and the debtor was precluded from relitigating the fraud issue by collateral estoppel. *Id.* at 4a. Accordingly, the bankruptcy court found the fraud judgment was nondischargeable under § 523(a)(2)(A). *Id.* at 40a.

Respondent appealed to the district court, contending that a lesser standard of proof was used in the underlying jury trial than is required under § 523(a)(2)(A). *Id.* at 4a-5a.

District Court Judge Dean Whipple, in affirming the bankruptcy court's decision in petitioners' favor, stated:

The keystone of our legal system is to give litigants a full opportunity to present their side of the litigation and allow a court or jury to reach a decision, and then abide by that decision. This has been done in this case. Appellant's trial in the U.S. District Court used Missouri Civil Instructions. Both sides were permitted to try their case in full, the jury was instructed to render a verdict based upon the facts and the law given in the court's instructions. A re-litigation of this case in Bankruptcy Court on the identical fact issues would be to permit the party who loses at a jury trial to have a second day in court on the same issue he and his opponent were fully heard previously. If permitted, all like cases would result in duplicitous litigation resulting in an unreasonable burden on the bankruptcy court.

*Id.* at 27a-28a.

Respondent appealed the ruling of the district court to the Eighth Circuit, seeking a determination that the jury's fraud verdict under Missouri law should have no preclusive effect on a subsequent bankruptcy proceeding under § 523(a). *Id.* at 5a-6a.

The Eighth Circuit determined that the verdict directing instruction in the fraud case imposed a "preponderance of the evidence" burden of proof. App. to Pet. for Cert. 8a.

The Court of Appeals noted that the courts are in conflict on the burden of proof in § 523(a) proceedings. *Id.* at 9a. The Court of Appeals stated:

The burden of proof for fraud or any of the other exceptions from discharge under Section 523(a) of the Bankruptcy Code is far from clear. The Bankruptcy Code is silent as to the burden of proof necessary to establish an exception to discharge under Section 523(a) including the exception for fraud.

*Id.*

Resolving the noted conflict for the Eighth Circuit, the Court of Appeals determined that the burden of proof under § 523(a) is "clear and convincing evidence" and reversed the decision of the district court. *Id.* at 14a.

### SUMMARY OF THE ARGUMENT

Bankruptcy Code § 523(a)(2)(A) provides that a debt procured by false representations or actual fraud is excepted from the general discharge of debts by bankruptcy. Where, as here, the elements of common law fraud are identical with the elements necessary to except the debt from discharge under § 523(a)(2)(A), the doctrine of collateral estoppel may be used to preclude relitigation of factual issues determined by a prior judgment against the debtor.

The Court of Appeals concluded erroneously that the creditor must establish the elements of § 523(a)(2)(A) by "clear and convincing" evidence. This holding precludes the creditor from using collateral estoppel to establish

nondischargeability where the underlying judgment was obtained under a "preponderance of the evidence" standard of proof because the plaintiffs' burden would be significantly greater in the subsequent § 523(a) proceeding.

The Bankruptcy Code and its legislative history are silent on the proper standard of proof in proceedings to determine the dischargeability of claims under § 523(a). At the time the Bankruptcy Code was enacted, there was a split of authority on the issue, with some courts requiring clear and convincing evidence to establish nondischargeability and others requiring that the exceptions to discharge be proven by a preponderance of the evidence. It may not be concluded that Congress intended to favor either result when the Code was enacted in 1978, because no clear majority rule had emerged.

This question of nondischargeability involves a private dispute over money which determines merely whether a debt continues. Certain types of claims involve issues of personal liberty or important personal rights which require a greater assurance of the accuracy of the fact-finding process through the imposition of a heightened standard of proof. Where the adjudication concerns particularly important personal rights more substantial than a monetary dispute, this Court has required that these rights may not be impaired unless clear and convincing evidence supports the result. However, the instant proceeding involves a purely monetary dispute between private litigants which does not warrant the application of a burden of proof greater than that applied in ordinary civil cases.

A majority of fraud cases, including those tried under the federal securities laws, are decided on a "preponderance of the evidence" standard of proof. The judicial imposition of a higher standard in nondischargeability cases would

result in an enormous burden on litigants and the bankruptcy courts. In each case where the dischargeability of a fraud judgment is at issue, the parties and bankruptcy court would be required to retry the entire case in the § 523(a) proceedings.

Without compelling justification, different evidentiary standards of proof should not be applied in civil proceedings involving a private dispute about money.

### ARGUMENT

#### I. COLLATERAL ESTOPPEL MAY BE APPLIED PROPERLY IN BANKRUPTCY PROCEEDINGS TO DETERMINE THE NONDISCHARGEABILITY OF A FRAUD JUDGMENT UNDER § 523(a) OF THE BANKRUPTCY CODE.

"[T]he whole premise of collateral estoppel is that once an issue has been resolved in a prior proceeding, there is no further factfinding function to be performed." *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 336 n. 23 (1979). Furthermore, collateral estoppel "has the dual purpose of protecting litigants from the burden of relitigating an identical issue with the same party and of promoting judicial economy by preventing needless litigation." *Parklane Hosiery Co.*, 439 U.S. at 326, citing, *Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation*, 402 U.S. 313, 328-329 (1970).

In *Brown v. Felsen*, 442 U.S. 127, 139 n. 10 (1979), this Court recognized the applicability of collateral estoppel to bankruptcy proceedings, stating that "[i]f, in the course of adjudicating a state-law question, a state court should determine factual issues using standards identical to those of § 17, then collateral estoppel, in the absence of countervailing statutory policy, would bar relitigation of those issues in the bankruptcy court."

For collateral estoppel to apply under federal law the issue precluded must have been (i) identical to the issue decided in the earlier action; (ii) actually litigated in the prior action; (iii) necessary and essential to the prior judgment; (iv) determined by a valid and final judgment. *Goss v. Goss*, 722 F.2d 599, 604 (10th Cir. 1983); Restatement (Second) of Judgments § 27 (1982).

In the original trial of the common law fraud claim, the verdict directing instruction compelled a petitioners' verdict if the jury found (i) the respondent made a representation intending reliance on such representation; (ii) the representation was false; (iii) respondent knew the representation was false; (iv) the representation was material to petitioners' decisions regarding sale of their stock; (v) petitioners relied on the representation; and (vi) that as a direct result of such representation each petitioner was damaged. J.A. (Pl. Ex. 2) 39-40, 50-51, 8, 9.

The jury's verdict was unanimously in favor of petitioners and against respondent on the common law fraud count as well as the 10b-5 and breach of fiduciary duty counts. The jury awarded punitive damages upon a finding that the misrepresentations were made willfully and maliciously. J.A. (Pl. Ex. 2) 28-31, 8, 9.

In comparing the six elements above with the elements required in § 523(a) litigation, it is evident that collateral estoppel was applied properly to petitioners' fraud judgment. The elements of a nondischargeability claim for fraud under § 523(a) are:

- (1) the debtor made false representations;
- (2) at the time debtor knew they were false;
- (3) debtor made them with the intention and purpose of deceiving the creditor;

(4) the creditor reasonably relied on such representations; and

(5) the creditor sustained the alleged injury as a proximate result of the representations having been made.

*Matter of Van Horne*, 823 F.2d 1285, 1287 (8th Cir. 1987).

The elements of common law fraud in Missouri are identical to the determination required under § 523(a). Accordingly, collateral estoppel should preclude relitigation of the nondischargeability issue.

## II. THE EIGHTH CIRCUIT'S DECISION THAT THE EXCEPTIONS TO DISCHARGE UNDER BANKRUPTCY CODE § 523(a) REQUIRE PROOF BY THE "CLEAR AND CONVINCING EVIDENCE" STANDARD IS WRONG AND IS NOT SUPPORTED BY THE STATUTORY LANGUAGE OR BY THE LEGISLATIVE HISTORY.

This Court has observed that when searching for congressional intent the language of the statute is the starting point. *Andrus v. Allard*, 444 U.S. 51, 56 (1979); *Reiter v. Sonotone, Corp.*, 442 U.S. 330, 337 (1979); 62 *Cases of Jam v. United States*, 340 U.S. 593, 596 (1951). The Bankruptcy Code does not mention the standard of proof to be applied in § 523(a) proceedings to determine the nondischargeability of fraud debts.

The legislative history of § 523(a) contains no reference to the proper standard of proof. See 1978 U.S. Code Cong. & Ad. News 5787, 6453. Regarding § 523(a)(2)(A) the legislative history states that it "is intended to codify current case law, e.g., *Neal v. Clark*, 95 U.S. 704 (1887), which interprets 'fraud' to mean actual or positive fraud rather than fraud implied by law." *Id.* The legislative

history reflects a concern for the elements of fraud, but not for the standard required to prove that a fraud debt is nondischargeable.

The courts were split on the issue of the proper standard of proof for exceptions to discharge when the Bankruptcy Code was enacted in 1978. Congress cannot be presumed to have been following a trend on that issue. (*Compare Sweet v. Ritter Finance Co.*, 263 F.Supp. 540, 543, (W.D.Va. 1967); *Gonzales v. Aetna Finance Co.*, 468 P.2d 15, 18 (Nev. 1970); *Atlas Credit Corp. v. Miller*, 216 So.2d 100, 101 (La. App. 1968); *Household Finance Corp. v. Altenberg*, 214 N.E.2d 667, 669-70 (Ohio 1966) applying preponderance of the evidence standard, with *Brown v. Buchanan*, 419 F.Supp. 199 (E.D.Va. 1975) applying the clear and convincing evidence standard.) "The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific." *Kelly v. Robinson*, 479 U.S. 36, 47 (1986) quoting *Midlantic National Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 501 (1986) quoting, in turn, *Swarts v. Hammer*, 194 U.S. 441, 444 (1904) (citations omitted). There was no judicially recognized or uniformly applied standard of proof for nondischargeability proceedings in 1978.

The Fourth Circuit has determined that the "preponderance of the evidence" standard should be applied to exception to discharge proceedings under Bankruptcy Code § 523(a). *Combs v. Richardson*, 838 F.2d 112 (4th Cir. 1988).

In *Combs*, as in the instant case, the court addressed the preclusive effect of the civil jury verdict in a subsequent bankruptcy proceeding. The bankruptcy court had determined that the jury verdict finding him guilty of assault

prevented Combs from relitigating the issue of whether the judgment was grounded upon a willful and malicious injury. Therefore, the bankruptcy court determined Combs' debt to Richardson was nondischargeable under § 523(a)(6) which states that:

(a) a discharge under § 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual from any debt — (6) for willful and malicious injury by the debtor to another entity or to the property of another entity.

Rejecting Combs' contention that the "clear and convincing evidence" standard should be applied to nondischargeability proceedings, the Fourth Circuit held:

The Bankruptcy Code is silent as to the standard of proof necessary to establish the exceptions to discharge in § 523. In the face of this silence, courts may not imply a higher standard than the preponderance standard normally applied in civil proceedings. Although the 'fresh start' philosophy of bankruptcy law requires that exceptions to discharge 'be confined to those plainly expressed,' *Gleason v. Thaw*, 236 U.S. 558, 562, 335 S.Ct. 287, 289, 59 L.Ed. 717 (1915), this policy does not justify judicial imposition of a heavier burden of proof on creditors seeking to have a debt determined nondischargeable under § 523(a)(6).

*Combs*, 838 F.2d at 116.

Four Circuits are in conflict with the Fourth Circuit and have concurred with the Eighth Circuit by holding that the standard of proof for discharge under § 523(a) is "clear and convincing evidence." *In re Phillips*, 804 F.2d 930, 932 (6th Cir. 1986); *In re Kimzey*, 761 F.2d 421, 423-24 (7th Cir. 1985);

*In re Black*, 787 F.2d 503, 505 (10th Cir. 1986); *Chrysler Credit Corp. v. Rebhan*, 842 F.2d 1257, 1262 (11th Cir. 1988); and *In re Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986). However, the Eighth Circuit has acknowledged the meager authority relied upon by these courts in decisions requiring a heightened standard of proof:

The circuits applying the clear and convincing standard have offered various explanations. All the circuits cite to various bankruptcy court decisions applying the clear and convincing standard. Two of the circuits cite to 3 *Collier on Bankruptcy*, ¶ 523.08 (15th ed. 1989) which states without explanation that the appropriate burden of proof is the clear and convincing standard. *In re Phillips*, 804 F.2d 930, 932 (6th Cir. 1986); *In re Black*, 787 F.2d 503, 505 (10th Cir. 1986). Two of the circuits state that the clear and convincing standard is necessary to overcome the presumption of innocence. *In re Black*, 787 F.2d 503, 505 (10th Cir. 1986); *In re Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986). Three circuits offer no rationale at all for favoring the more stringent standard. *Chrysler Credit Corp. v. Rebhan*, 842 F.2d 1257, 1262 (11th Cir. 1988); *In re Phillips*, 804 F.2d 930, 932 (6th Cir. 1986); *In re Kimzey*, 761 F.2d 421, 423-24 (7th Cir. 1985).

App. to Pet. for Cert. 11a-12a.

The Circuits applying the heightened "clear and convincing" standard rely upon either bankruptcy court authority or the equivocal reference in *Collier* to support their holdings. Contrary bankruptcy authority was ignored, and no consistent rationale was offered beyond the unsupported observation that a "clear and convincing" evidentiary standard is ordinarily applied in nondischargeability

cases. *Matter of Van Horne*, 823 F.2d 1285, 1287 (8th Cir. 1987); *In re Phillips*, 804 F.2d 930, 932 (6th Cir. 1986); *In re Black*, 787 F.2d 503, 505 (10th Cir. 1986); *In re Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986); *In re Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986); *In re Kimzey*, 761 F.2d 421, 424 (7th Cir. 1985).

The Eighth Circuit expressed reliance upon the "fresh start" policy of the Bankruptcy Code for its determination that the "clear and convincing evidence" standard is the proper standard of proof under § 523(a). App. to Pet. for Cert. 13a; *Matter of Van Horne*, *supra*, 823 F.2d at 1287. This "fresh start" policy provides for "'a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt,'" *Brown v. Felsen*, 442 U.S. at 128, quoting, *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

Here, the "fresh start" policy has been misapplied. The Eighth Circuit has failed to give effect to the rule that "[b]y seeking discharge, however, respondent placed the rectitude of his prior dealings squarely in issue, for, as the Court has noted, the Act limits that opportunity to the 'honest but unfortunate debtor.'" *Brown v. Felsen*, 442 U.S. at 128, quoting, *Local Loan Co. v. Hunt*, 292 U.S. at 244.

Respondent has been found guilty of common law fraud under Missouri law, which conduct the jury found "willful, wanton, and malicious." J.A. (Pl. Ex. 2) 29, 47-48, 8, 9. This determination precludes him from claiming to be an "honest but unfortunate debtor."

As discussed below, a majority of states recognize that common law fraud may be proven by some formulation amounting to a "preponderance" standard. See Part III, *infra* at 17. The debt which petitioners seek to exclude from the general discharge is, without question, an obligation

resulting from fraud in connection with the sale of securities. A unanimous jury found the debtor-respondent had defrauded petitioners and awarded actual and punitive damages upon a finding of intentional and malicious misconduct.

The issue *sub judice* is not whether petitioners must prove fraud by clear and convincing evidence—that issue was decided long before the bankruptcy proceeding was commenced. The issue before this Court is whether a creditor must prove by clear and convincing evidence that his existing fraud judgment is within the exception to discharge of § 523(a) of the Bankruptcy Code. It is submitted respectfully that there is no cogent reason for imposing a heightened standard of proof in a proceeding to resolve a purely monetary dispute between private parties.

This Court has recognized often that a heightened standard of proof is appropriate in cases where a greater level of confidence in the accuracy of the fact-finding process is mandated by Due Process. These cases involve a determination of individual rights which are "particularly important" and "more substantial than a mere loss of money." *Cruzan v. Director, Missouri Department of Health*, \_\_\_ U.S. \_\_\_ No. 88-1503, slip op. at 18-19 (June 25, 1990) (termination of nutrition and hydration of person in persistent vegetative state); *Santosky v. Kramer*, 455 U.S. 745 (1982) (termination of parental rights); *Addington v. Texas*, 441 U.S. 418 (1979) (civil commitment); *Woodby v. Immigration Service*, 385 U.S. 276 (1966) (deportation proceedings); *Gonzales v. Landon*, 350 U.S. 920 (1955) (expatriation); *Schneiderman v. United States*, 320 U.S. 118 (1943) (denaturalization proceedings). However, the "imposition of even severe civil sanctions that do not implicate such interests has been permitted after

proof by a preponderance of the evidence." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389-90 (1983).

At issue in the instant proceeding is the question of whether a civil monetary obligation shall continue or be extinguished by the discharge of bankruptcy. The affected parties are private litigants with purely monetary claims at stake. As this Court observed in *Addington*:

Generally speaking, the evolution of this area of the law has produced across a continuum three standards or levels of proof for different types of cases. At one end of the spectrum is the typical civil case involving a monetary dispute between private parties. Since society has a minimal concern with the outcome of such private suits, plaintiff's burden of proof is a mere preponderance of the evidence. The litigants thus share risk of error in roughly equal fashion.

441 U.S. at 423.

Recognizing that this Court has observed in *dicta* that the standard of proof in civil fraud cases is "clear and convincing evidence," [e.g. *Addington*, *supra*, 441 U.S. at 424], it is undisputed that common law fraud may be proven in Missouri under a "preponderance" standard. In fact, a majority of jurisdictions allow common law fraud to be proven by a preponderance of the evidence. See, *infra* Section III at 17. In addition, the judicially adopted standard of proof in federal securities fraud cases between private litigants under the Securities Exchange Act of 1934 is a "preponderance" standard. *Herman & MacLean v. Huddleston*, *supra*, 459 U.S. at 389-90. It is submitted respectfully that the decisions holding that a heightened standard of proof applies in § 523(a) nondischargeability proceedings rely on the erroneous notion that all fraud cases must be proven by clear and convincing evidence.

### III. THE MAJORITY OF STATES ALLOW FRAUD TO BE PROVEN BY "PREPONDERANCE OF THE EVIDENCE"; BECAUSE CERTAIN FEDERAL SECURITY ANTI-FRAUD ACTIONS MAY BE PROVEN BY THE SAME STANDARD, AN ADDITIONAL BURDEN ON JUDICIAL RESOURCES WILL RESULT IF THIS COURT REQUIRES EXCEPTIONS TO DISCHARGE UNDER § 523(a) TO BE PROVEN BY "CLEAR AND CONVINCING EVIDENCE."

A majority of states apply a "preponderance" standard of proof in some or all civil fraud actions<sup>1</sup>. Most jurisdictions have decisions which recite that fraud is never

<sup>1</sup> *First Virginia Bankshares v. Benson*, 559 F.2d 1307 (5th Cir. 1977) cert. den., 435 U.S. 952 (1978) (applying Alabama law) (fraud is proved by a preponderance of the evidence); *Dairy Queen v. Travelers Indemnity Co.*, 748 P.2d 1169, 1171 (Alaska 1988) ("no more than a preponderance of the evidence is necessary to establish fraud"); *Tipp v. United Bank of Durango, Colo.*, 745 S.W.2d 141, 143 (Ark. App. 1988) ("the party who alleges and relies upon fraud bears the burden of proving fraud by a preponderance of the evidence"); *Liodas v. Sahadi*, 19 Cal. 3d 278, 137 Cal. Rptr. 635, 562 P.2d 316, 322 (civil fraud proved by preponderance of the evidence); *Goodfellow v. Kattnig*, 533 P.2d 58, 60 (Colo. Ct. App. 1975) (there is a single burden of proof in all civil actions: proof by a preponderance of the evidence); *Kern v. NCD Industries, Inc.*, 316 A.2d 576 (Del. Ch. Ct. 1973) (fraud proved by a preponderance of the evidence); *Powerhouse, Inc. v. Walton*, 557 So.2d 186, 187 (Fla. App. 1 Dist. 1990) ("the quantum of proof necessary to support an action for fraud is 'preponderance' or 'greater weight' of the evidence"); *L & S Enterprises Co. v. Great American Ins. Co.*, 454 F.2d 457, 460 (7th Cir. 1971) (diversity action applying Illinois law) ("fraud need only be proved by the preponderance of the evidence"); *Parke County v. Ropak, Inc.*, 526 N.E.2d 732, 736 (Ind. App. 1 Dist. 1988) (fraud must be proved by a preponderance of the evidence); *LaCaze v. State, Through DOTD*, 541 So. 2d 322, 325 (La. App. 3 Cir. 1989) ("Fraud need only be proved by a

preponderance of the evidence and it may be established by circumstantial evidence"); *General Elec. Credit Corp. v. Wolverine Ins.*, 362 N.W.2d 595, 601 (Mich. 1984) (fraud must be established by a preponderance of the evidence); *Crawford v. Smith*, 470 S.W.2d 529, 531 (Mo. banc 1971) (fraud is proved by a preponderance of the evidence); *Poulsen v. Treasure State Industries, Inc.*, 626 P.2d 822 (Mont. 1981) ("Fraud can never be presumed but must be proved by a preponderance of the evidence"); *Tobin v. Flynn & Larsen Implement Co.*, 369 N.W.2d 96, 99 (Neb. 1985) (fraud suits at law "must be proved by a preponderance of the evidence"); *Medivox Productions, Inc. v. Hoffman-LaRoche, Inc.*, 107 N.J. Super. 47, 256 A.2d 803 (1969) (fraud is determined in actions at law by a preponderance of the evidence); *Echols v. N.C. Ribble Co.*, 511 P.2d 566, 571 (N.M. 1973) (fraud is proved by a preponderance of the evidence. "In New Mexico, the doctrine of 'clear, strong, and convincing evidence' does not apply to burden of proof. It applies in determining whether the evidence in support of the elements of fraud is substantial"); *Maynard v. Durham and Southern Railway Co.*, 112 S.E.2d 249, 252 (N.C. 1960), *rev'd on other grounds*, 365 U.S. 160 (1961) (in an action to set aside an instrument based on fraud "the burden of proof to establish such allegation is by the preponderance or greater weight of the evidence"); *Manning v. Len Immke Buick, Inc.*, 28 Ohio App. 2d 203, 276 N.E.2d 253 (1971) ("the degree of proof necessary to show fraud in a civil action for damages is by a preponderance of the evidence." Such evidence must be clear and convincing); *Ostalkiewicz v. Guardian Alarm*, 520 A.2d 563, 569 (R.I. 1987) ("Fraud in a civil suit need only be proven by a fair preponderance of the evidence"); *Jennings v. Jennings, S.D.*, 309 N.W.2d 809, 812 (1981) (fraud is proved by the preponderance of the evidence standard); *Calhoun v. Baylor*, 646 F.2d 1158 (6th Cir. 1981) (applying Tennessee law) (Tennessee law requires only that fraud be proved by a preponderance of the evidence); *Frankfurt v. Wilson*, 353 S.W.2d 490 (Tex. App. 1961) ("The burden of proof on the part of the plaintiff to establish fraud [is] by a preponderance of the evidence").

Two other states combine the language of the two standards, but the resulting standard remains "preponderance of the evidence" with "clear and convincing" indicating the quality, not quantity, of the proof. *Kristerin Development Co. v. Granson Inv.*, 394 N.W.2d 325, 332 (Iowa 1986) (the elements of fraud must be shown by "a preponderance of clear, satisfactory, and convincing evidence") and *Newell v. Krause*, 722 P.2d 530, 536 (Kan. 1986) ("clear and convincing evidence is not a quantum of proof, but rather a quality of proof; thus the plaintiff established

presumed and must be established affirmatively with "clear" or "convincing" proof. However, a careful analysis reveals that many of these decisions concern the quality or character of the proof required and not the amount or weight of evidence required to overcome the risk of nonpersuasion. Missouri is an excellent example of the divergence of meaning created by these anomalous statements.

Missouri follows the rule that civil fraud does not require proof beyond the normal civil preponderance standard. *Crawford v. Smith*, 470 S.W.2d 529, 531 (Mo. banc 1971). The Missouri pattern jury instructions requires the

fraud by a preponderance of the evidence, but this evidence must be clear and convincing in nature").

Case law from four more states indicates that fraud is to be proved by a preponderance of the evidence, although there exists case law to the contrary. *Martin v. Guaranty Reserve Life Ins. Co.*, 155 N.W.2d 744, 747 (Minn. 1968) (fraud is proved by a preponderance of the evidence) *but see*, *Weise v. Red Owl Stores, Inc.*, 175 N.W.2d 184, 187 (Minn. 1970) ("fraud must be proved by clear and convincing evidence, especially where a party seeks to avoid the affects of a written instrument"); *Silk v. Phillips Petroleum Co.*, 760 P.2d 174 (Okla. 1988) ("fraud may not be presumed by the jury from circumstances, it must arise as any other issue of fact from a preponderance of all the evidence") *but see*, *In re Darren Todd H.*, 615 P.2d 287 (Okla. 1980) ("Oklahoma is one of the jurisdictions which requires proof of fraud by clear and convincing proof"); *Gilbert v. Midsouth Machinery Company, Inc.*, 267 S.C. 211, 227 S.E.2d 189 (1976) ("while the evidence [to prove fraud] must be clear and convincing, such clear and convincing proof may be met by a preponderance of the evidence") *but see*, *Rutledge v. St. Paul Fire and Marine Ins. Co.*, 286 S.C. 360, 334 S.E.2d 131, 138 (1985) (standard of proof in a fraud and deceit case is clear and convincing evidence); *Hayseeds, Inc. v. State Farm Fire & Cas.*, 352 S.E.2d 73 (W.Va. 1986) ("'clear and satisfactory' in cases involving fraud or false swearing, may be defined to be a preponderance of evidence sufficient to overcome the presumption of innocence of moral turpitude or crime") *but see*, *Tri-State Asphalt Products v. McDonough Co.*, No. 18990 (Supreme Ct. App. W.Va. 1990) (allegations of fraud must be established by clear and convincing proof).

"preponderance" burden of proof instruction be given in fraud cases. Missouri Approved Jury Instruction 33.01 (1981). This instruction was used in the jury trial of the underlying fraud action in this case. J.A. at 106-07.

Nevertheless, the Missouri courts persist in expressing the view that fraud must be "proven" by clear and convincing evidence. See, e.g., *Centerre Bank of Independence v. Bliss*, 765 S.W.2d 276 (Mo. App. 1988); *Barrett v. Flynn*, 728 S.W.2d 288 (Mo. App. 1987). The only way to reconcile these seemingly inconsistent expressions of the Missouri law is to recognize that the burden of proof is by a preponderance of the evidence, as dictated by controlling authority of the Missouri Supreme Court En Banc. The expression of a "clear and convincing" evidentiary requirement relates to the character of the evidence—not to the quantity of evidence required to prevail.

In addition to common law fraud, cases decided under the anti-fraud provisions of the federal securities laws are proven under a "preponderance" standard. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983) (private action under § 10(b) of the Securities and Exchange Act of 1934); *Securities and Exchange Commission v. Joiner Corp.*, 320 U.S. 344, 355 (1943) (action under § 17(a) of the Securities Act of 1933).

Because most fraud actions brought by private litigants are tried under a "preponderance" standard of proof, imposition of the heightened "clear and convincing" standard to nondischargeability proceedings under § 523(a) will preclude the use of collateral estoppel in most instances and will impose substantial additional burdens on the litigants and bankruptcy courts. In each instance where a fraud judgment is obtained under a "preponderance" standard, the entire action must be retried in the bankruptcy court on the issue of dischargeability.

The judicial creation of a different standard of proof in bankruptcy discharge cases is inconsistent with the normal burden placed on the parties in a civil action involving monetary claims and is unwarranted because of the additional burden it would place on the parties and bankruptcy courts. Without compelling justification, the burden of proof in bankruptcy discharge cases should be no greater than that imposed in the underlying action for fraud under state law.

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## CONCLUSION

For the foregoing reasons, petitioners request that the judgment of the Court of Appeals be reversed and the case remanded to the District Court for entry of judgment in petitioners' favor on the claims under § 523(a)(2) of the Bankruptcy Code.

Respectfully submitted,

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**In the Supreme Court of the United States**

OCTOBER TERM, 1990

COY R. GROGAN, ET AL., PETITIONERS

v.

FRANK J. GARNER, JR.

ON WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES,  
THE SECURITIES AND EXCHANGE COMMISSION,  
AND THE  
FEDERAL DEPOSIT INSURANCE CORPORATION  
AS AMICI CURIAE SUPPORTING PETITIONERS

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*Federal Deposit Insurance Corporation*

*Washington, D.C. 20429*

Supreme Court, U.S.

E D

JUL 3 1990

JOSEPH F. SPANIOL, JR.  
CLERK

### **QUESTION PRESENTED**

Whether a claim that a debt arises from "false pretenses, a false representation, or actual fraud," and so is excepted from discharge under Section 523(a) of the Bankruptcy Code, must be proved by a preponderance of the evidence or by clear and convincing evidence.

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**In the Supreme Court of the United States**

OCTOBER TERM, 1990

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No. 89-1149

COY R. GROGAN, ET AL., PETITIONERS

v.

FRANK J. GARNER, JR.

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ON WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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BRIEF FOR THE UNITED STATES,  
THE SECURITIES AND EXCHANGE COMMISSION,  
AND THE  
FEDERAL DEPOSIT INSURANCE CORPORATION  
AS AMICI CURIAE SUPPORTING PETITIONERS

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INTEREST OF THE UNITED STATES, THE  
SECURITIES AND EXCHANGE COMMISSION, AND  
THE FEDERAL DEPOSIT INSURANCE CORPORATION

The Court's resolution of the question presented in this case will affect the civil enforcement of federal antifraud statutes by the United States, the Securities and Exchange Commission (SEC), and the Federal Deposit Insurance Corporation (FDIC), as well as other federal agencies. The United States obtains money judgments under the False Claims Act, 31 U.S.C. 3729-3731, against persons who defraud the federal government. The False Claims Act expressly provides that the government need prove fraud only by a preponderance of the evidence. 31 U.S.C. 3731(c).

(1)

The SEC obtains judgments, under a preponderance of the evidence standard, for violations of the antifraud provisions of the federal securities laws. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983). The SEC's interest in this case arises not only because of the agency's role in obtaining monetary relief in its own enforcement actions, but also because private actions under the federal securities laws are a necessary supplement to the SEC's enforcement actions, see *Basic Inc. v. Levinson*, 485 U.S. 224, 230-231 (1988), and because the SEC acts as advisor to the courts in bankruptcy reorganization cases pursuant to Section 1109(a) of the Bankruptcy Code, 11 U.S.C. 1109(a).

The FDIC and the Resolution Trust Corporation (RTC) obtain money judgments against persons who defraud federally insured financial institutions.<sup>1</sup> The FDIC proceeds under a variety of antifraud laws that require proof only by a preponderance of the evidence, including the enforcement provisions of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. 1818(i), the director and officer liability provisions of the FDIA, 12 U.S.C. 1821 (k)-(l), the civil provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. 1964, and the antifraud provisions of the securities laws and the Commodity Exchange Act (CEA), 7 U.S.C. 1 *et seq.* Moreover, Congress expressly provided in 12 U.S.C. 1833a(e) that the preponderance standard applies to actions brought by the Attorney General to recover civil penalties for certain fraudulent conduct involving financial institutions.<sup>2</sup>

<sup>1</sup> Congress created the RTC "to contain, manage, and resolve failed savings associations." Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 101(7), 103 Stat. 183.

<sup>2</sup> Other federal agencies also obtain civil fraud remedies under a preponderance of the evidence standard. For example, a preponderance standard applies to Medicare and Medicaid fraud

If the Court were to hold that proof of fraud under Section 523(a) must be by clear and convincing evidence, fraud judgments obtained after a full trial on the merits under a preponderance of the evidence standard would not be recognized in bankruptcy courts. Victims of fraud would therefore be required to prove fraud a second time, by clear and convincing evidence, in the bankruptcy proceedings. Such proceedings would be costly to the victims and burdensome to the bankruptcy courts. The United States, the SEC, the FDIC, and other federal agencies have a strong interest in opposing a rule that imposes such an unwarranted burden on victims of fraud, and in preventing the bankruptcy courts from becoming a haven for wrongdoers.

### STATEMENT

1. Petitioners were employees and minority shareholders of STI-Missouri, a corporation that repaired and refurbished railroad rolling stock. Respondent was the president and majority shareholder of the corporation. Petitioners sued respondent in the United States District Court for the Western District of Missouri, alleging that respondent had defrauded them in connection with the sale of securities of STI-Missouri and another corporation. Petitioners sought damages for violations of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), as well as for

claims. See 42 U.S.C. 1320a-7a; 42 C.F.R. 1003.114(a). In addition, where the Internal Revenue Service establishes that any part of a tax underpayment is attributable to fraud, the entire underpayment is subject to fraud penalties unless the taxpayer establishes, by a preponderance of the evidence, that the underpayment is not attributable to fraud. See Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(a), 103 Stat. 2395 (to be codified at 26 U.S.C. 6663(b)). The Commodity Futures Trading Commission's findings of violations of the antifraud provisions of the CEA also are reviewed under a preponderance standard. See *Lawrence v. CFTC*, 759 F.2d 767, 773 (9th Cir. 1985).

common law fraud and breach of fiduciary duty. The case was tried before a jury. The district court did not specifically instruct the jury as to the applicable standard of proof. Instead, it instructed the jury generally that "[i]f the evidence in the case does not cause you to believe a particular proposition submitted, then you cannot return a verdict requiring belief of the proposition." Pet. App. 24a. The jury returned a verdict for petitioners, awarding damages on all counts and punitive damages on the common law fraud count. The Court of Appeals for the Eighth Circuit reduced the amount of damages, but otherwise affirmed the judgment for petitioners. *Grogan v. Garner*, 806 F.2d 829 (1986). See Pet. App. 3a-5a, 16a-17a, 30a-31a.

2. In October 1985, while respondent's appeal of the fraud judgment was pending in the court of appeals, respondent filed a petition in the United States Bankruptcy Court for the Western District of Missouri for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. 1101 *et seq.* The petition listed the fraud judgment as a dischargeable debt. In May 1986, petitioners filed a complaint in the bankruptcy court for a determination that their judgment debt should be expected from discharge pursuant to Section 523 of the Bankruptcy Code, 11 U.S.C. 523.<sup>3</sup> At the trial on their complaint, petitioners

<sup>3</sup> Section 523 provides, in part:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

\* \* \*

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing—

submitted copies of relevant pleadings and documents from the prior fraud action, including the complaint, the jury instructions, the district court's judgment, and the court of appeals' decision. The bankruptcy court determined that each of the elements necessary to establish "actual fraud" under Section 523 had been proved in the prior action. Applying principles of collateral estoppel, the court held that the judgment debt was not dischargeable under Section 523(a)(2)(A). The bankruptcy court rejected respondent's contention that collateral estoppel did not apply because the jury in the prior fraud action had not been instructed that fraud must be proved by clear and convincing evidence. The bankruptcy court concluded that there was no real distinction between the preponderance of the evidence standard and the clear and convincing evidence standard. Pet. App. 3a-4a, 18a-20a, 31a, 40a. The district court agreed with the reasoning of the bankruptcy court and affirmed its judgment. Pet. App. 16a-29a.

3. The Court of Appeals for the Eighth Circuit reversed. The court stated that the standard of proof necessary to establish an exception from discharge under Section 523(a) is "far from clear," recognizing that those courts of appeals requiring proof by clear and convincing evidence often have done so without a satisfactory ex-

- (i) that is materially false;
- (ii) respecting the debtor's or an insider's financial condition;
- (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
- (iv) that the debtor caused to be made or published with intent to deceive.

In addition, Section 523(a)(4) of the Bankruptcy Code, 11 U.S.C. 523(a)(4), excepts from discharge in bankruptcy any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."

planation. Pet. App. 9a-12a. Moreover, the court recognized, neither the language of Section 523 nor its legislative history addresses the issue. Pet. App. 13a. The court nevertheless held that the statutory exception to discharge for fraud must be proved by clear and convincing evidence rather than by a preponderance of the evidence. The court surmised that Congress was aware "that the prevailing view at the time of adoption was that fraud, for both section 523 and state common law purposes, had to be proved by clear and convincing evidence." *Ibid.* The court also stated that a preponderance of the evidence standard of proof would "effectively read[ ] the 'fresh start' policy out of \* \* \* the Code." *Ibid.* Because the preponderance standard is a lower standard than the clear and convincing evidence standard, the court of appeals held that the bankruptcy court had erred in giving collateral estoppel effect to the prior fraud judgment. Pet. App. 9a-10a, 12a, 14a.

#### SUMMARY OF ARGUMENT

1. a. Neither the Bankruptcy Code nor its legislative history expressly prescribes the standard of proof applicable to a claim that a debt arises from the debtor's fraudulent conduct and therefore is excepted from discharge under Section 523(a) of the Code. In the absence of any contrary expression, the most natural inference is that Congress intended such claims to be subject to the preponderance of the evidence standard generally applicable in civil proceedings. The debtor's interest in obtaining a discharge of debts arising from fraudulent conduct is not a constitutional or fundamental individual right that warrants application of a heightened standard of proof. In any event, Congress has determined that the "fresh start" provided by a discharge is available only to honest debtors, and has recognized, in Section 523(a), a countervailing and equally important interest of the victims of fraud in preserving their right to recover from dishonest debtors. Thus, there is no basis for concluding

that a defrauding debtor's interest in a complete discharge takes precedence over the innocent victim's interest and, consequently, no basis for favoring the debtor by creating an exception to the general rule of proof and applying a clear and convincing evidence standard. The court below therefore erred when it reasoned that the preponderance of the evidence standard in this context would "read[ ] the 'fresh start' policy out of \* \* \* the Code." Pet. App. 13a. Congress wrote that policy out of the Code with respect to debts arising from fraud when it enacted Section 523.

b. To the extent that the Bankruptcy Code and its legislative history shed light on the question, they support application of the typical preponderance standard. The legislative history of Section 727 of the Bankruptcy Code states that the bankruptcy court, in a Chapter 7 proceeding, may deny the debtor a discharge as to all debts if it is shown, by a preponderance of the evidence, that the debtor has engaged in certain fraudulent conduct in connection with the bankruptcy proceeding. There is no reason to suppose that Congress would apply a higher standard of proof to the less important question whether a particular debt should be excepted from discharge because of fraud. In addition, application of the clear and convincing standard in this context would depart from the standard of proof in important federal antifraud statutes that require proof only by a preponderance of the evidence. The result would be that some persons determined to be guilty of fraud under important congressional enactments would escape liability by declaring bankruptcy, either because plaintiffs would elect not to devote the resources to trying the case a second time, or because plaintiffs, who would often be forced to present stale evidence, could not reprove fraud by clear and convincing evidence. There is no evidence that Congress intended such a result. On the contrary,

the basic intent of Section 523(a) is that debtors *not* escape liability for fraud. This Court should not embrace such an outcome, when the more natural application of the typical preponderance rule avoids this troubling anomaly.

2. The court below based its decision on a "presum[ption]" that Congress was aware when it enacted Section 523 that the "prevailing view" was that fraud had to be proved by clear and convincing evidence. Pet. App. 13a. In fact, there was no consistent pre-Code practice of requiring clear and convincing proof either to establish fraud or to prove that a debt was incurred by fraud. State courts were then and are now divided over the appropriate standard of proof in civil actions for fraud. At the time Section 523 was enacted, some courts required that fraud exceptions to discharge be proved by clear and convincing evidence, while others applied the preponderance standard. Thus, even if Congress should be "presumed" to be aware of existing law in the absence of any evidence that the pertinent body of law was called to its attention, Congress cannot be assumed to have understood that fraud had to be proved by clear and convincing evidence. Moreover, the original reasons for applying a higher standard of proof in certain equitable actions for fraud have little or no application to modern fraud actions for damages.

## ARGUMENT

### I. THE PREPONDERANCE OF THE EVIDENCE STANDARD APPLIES IN ACTIONS UNDER SECTION 523(a) OF THE BANKRUPTCY CODE TO EXCEPT FROM DISCHARGE DEBTS INCURRED BY FRAUD

Section 523(a)(2) of the Bankruptcy Code, 11 U.S.C. 523(a)(2), excepts from discharge in bankruptcy any debt of an individual debtor that arises from that debtor's fraudulent conduct.<sup>4</sup> The court of appeals held that a creditor seeking to except a claim from discharge under Section 523(a)(2) must prove fraud by clear and convincing evidence. Under the court of appeals' decision, principles of collateral estoppel would not apply where, as here, a prior fraud judgment was obtained under a preponderance of the evidence standard. This is an unwarranted result. A plaintiff who has proved fraud in a nonbankruptcy court need not, and should not, be required to retry the case in the bankruptcy court to preserve the prior judgment from discharge.<sup>5</sup>

<sup>4</sup> See note 3, *supra*.

<sup>5</sup> We agree with the courts below that principles of collateral estoppel apply in bankruptcy proceedings. See Pet. App. 6a-7a, 35a-36a. Although the Court formally reserved this question in *Brown v. Felsen*, 442 U.S. 127 n.10 (1979), it subsequently stated that "[i]n many cases \* \* \* principles of issue preclusion would obviate the need for a bankruptcy court to reexamine factual questions." *Kelly v. Robinson*, 479 U.S. 36, 48 n.8 (1986). Collateral estoppel, unlike the doctrine of *res judicata* at issue in *Brown v. Felsen*, *supra*, applies only to those factual issues actually and necessarily determined in prior litigation between the parties. See *Montana v. United States*, 440 U.S. 147, 153 (1979); *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 326 n.5 (1979). Consequently, there is no danger that bankruptcy issues will be determined in cases where the parties lack an adequate incentive to litigate them. Where, as here, factual issues are actually litigated in nonbankruptcy courts, application of collateral estoppel principles is appropriate and fully consistent with the prior decisions of this Court. See generally *Heiser v. Woodruff*, 327 U.S. 726 (1946);

**A. In a Proceeding to Except from Discharge a Debt Incurred by Fraud, the Balance of Interests of the Parties Requires Application of the Preponderance of the Evidence Standard**

1. Section 523 does not prescribe the standard of proof applicable to claims that a debt is excepted from discharge because of the debtor's fraudulent conduct. The legislative history of Section 523 and its predecessor, Section 17 of the Bankruptcy Act 11 U.S.C. 35 (1976), also are silent on this issue.<sup>6</sup> Where Congress has not specified a standard of proof, and the Constitution does not require a particular standard, the courts will fill the gap. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983); *Steadman v. SEC*, 450 U.S. 91, 95 (1981).<sup>7</sup>

*Fischer v. Pauline Oil & Gas Co.*, 309 U.S. 294, 302-303 (1940); *Davis v. Friedlander*, 104 U.S. 570 (1881). Virtually every court of appeals to consider the question has held that collateral estoppel is applicable in discharge exception proceedings. See *In re Braen*, 900 F.2d 621 (3d Cir. 1990); *Combs v. Richardson*, 838 F.2d 112, 114 (4th Cir. 1988); *Klingman v. Levinson*, 831 F.2d 1292 (7th Cir. 1987); *In re Shuler*, 722 F.2d 1253, 1256 (5th Cir.), cert. denied, 469 U.S. 817 (1984); *Lovell v. Mixon*, 719 F.2d 1373, 1376 (8th Cir. 1983); *Spilman v. Harley*, 656 F.2d 224, 226 n.2 (6th Cir. 1981). See also *In re Lombard*, 739 F.2d 499, 503 (10th Cir. 1984) (collateral estoppel applies at least where the bankruptcy court does not have exclusive jurisdiction). But cf. *In re Houtman*, 568 F.2d 651 (9th Cir. 1978) (judgment of a nonbankruptcy court establishes only prima facie case of non-dischargeability).

We also agree with the court of appeals that collateral estoppel applies in this case only if Section 523(a) requires proof of fraud by a preponderance of the evidence. See *Price Waterhouse v. Hopkins*, 109 S. Ct. 1775 (1989).

<sup>6</sup> See S. Rep. No. 989, 95th Cong., 2d Sess. 77-80 (1978); H.R. Rep. No. 595, 95th Cong., 1st Sess. 129-132, 363-365 (1977); S. Rep. No. 1173, 91st Cong., 2d Sess. (1970); H.R. Rep. No. 1502, 91st Cong., 2d Sess. (1970); H.R. Rep. No. 1409, 75th Cong., 1st Sess. (1937); S. Rep. No. 1916, 75th Cong., 3d Sess. (1938).

<sup>7</sup> The determination whether a debt is excepted from discharge under Section 523(a) is a matter of federal bankruptcy law. See

The function of a standard of proof is to "allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision." *Addington v. Texas*, 441 U.S. 418, 423 (1979). The standard of proof performs this function by "instruct[ing] the factfinder concerning the degree of confidence our society thinks he should have in the correctness of factual conclusions." *Ibid.* (quoting *In re Winship*, 397 U.S. 358, 370 (1970) (Harlan, J., concurring)). The preponderance standard is the only standard of proof that results in a roughly equal allocation of the risk of error between the parties; "[a]ny other standard expresses a preference for one side's interests." *Huddleston*, 459 U.S. at 390; *Addington v. Texas*, 441 U.S. at 423.<sup>8</sup> Consequently, the Court has recognized that the "preponderance-of-the-evidence standard [is] generally applicable in civil actions," unless "particularly important individual interests or rights are at stake." *Huddleston*, 459 U.S. at 389-390. See also *Santosky v. Kramer*, 455 U.S. 745, 756 (1982); *Addington v. Texas*, 441 U.S. at 423.<sup>9</sup> Where no constitutional or other very important

*Brown v. Felsen*, 442 U.S. at 136. Accordingly, the standard of proof in a Section 523(a) proceeding is also a matter of federal law.

<sup>8</sup> A heightened standard of proof not only increases the probability that an error will favor the debtor, but also increases the overall probability of an erroneous decision. See Winter, *The Jury and the Risk of Nonpersuasion*, 5 Law & Soc. Rev. 335, 337 (1970); Ball, *The Moment of Truth: Probability Theory and Standards of Proof*, 14 Vand. L. Rev. 807, 816-817 (1961).

<sup>9</sup> The Court has required proof by clear and convincing evidence only where constitutional or other highly important individual interests are at stake. See, e.g., *Santosky v. Kramer*, *supra* (proceeding to terminate parental rights); *Addington v. Texas*, *supra* (involuntary civil commitment proceedings); *Boddie v. Connecticut*, 401 U.S. 371 (1971) (right to sue for divorce); *Woodby v. INS*, 385 U.S. 276 (1966) (determination of alien's deportability); *New York Times v. Sullivan*, 376 U.S. 254 (1964) (First Amendment rights); *Chaunt v. United States*, 364 U.S. 350 (1960) (proceeding to revoke United States citizenship); *Schneiderman v. United*

individual right is implicated, the Court has applied the preponderance standard, even where severe civil sanctions may be imposed. See, e.g., *Huddleston*, 459 U.S. at 389-390; *Steadman v. SEC*, *supra* (proceeding to permanently bar individual, on grounds of fraud, from securities industry); *United States v. Regan*, 232 U.S. 37, 48-49 (1914) (civil suit that may expose defendant to criminal prosecution). In this case, as in *Huddleston*, "the balance of interests \* \* \* warrants use of the preponderance standard." 459 U.S. at 390.

2. A discharge in bankruptcy affords the debtor "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). But Congress has made this fresh start available only to "the honest debtor." *Ibid.* In enacting Section 523(a), Congress determined that the fresh start policy should not override an innocent victim's interest in obtaining redress for fraud. As the Court observed in the context of another exception to discharge, the fresh start policy "cannot override the specific policy judgments made by Congress in enacting the [exceptions to discharge]." *United States v. Sotelo*, 436 U.S. 268, 279 (1978); see also 1 D. Cowans, *Cowans Bankruptcy Law and Practice* § 6.2, at 691-692 (1989) (the fresh start policy "is not so important \* \* \* as to negate other important policies which the law feels a responsibility to foster and abet").

This Court has held that the debtor's interest in obtaining a discharge is not a constitutional right or a fundamental interest. In *United States v. Kras*, 409 U.S. 434, 446 (1973), the Court held that "[t]here is no constitutional right to obtain a discharge of one's debts in

*States*, 320 U.S. 118, 125, 159 (1943) (denaturalization proceedings). See also *Cruzan v. Director, Missouri Dep't of Health*, No. 88-1503 (June 25, 1990) slip op. 17-19 (State may require clear and convincing proof of patient's choice to discontinue life-sustaining treatment).

bankruptcy." Because the Court saw "no fundamental interest that is gained or lost depending on the availability of a discharge in bankruptcy," *id.* at 445, it held that a debtor who fails to pay bankruptcy court fees may be denied a discharge of *all* debts. The more limited question whether a particular debt is subject to discharge can hardly rise above the level of importance of the complete denial of a discharge in bankruptcy at issue in *Kras*.

On the other hand, the innocent victim's interest in obtaining compensation for fraud is at least as important as the defrauding debtor's interest in obtaining a fresh start. The policy against discharging debts incurred by fraud is deeply embedded in the bankruptcy law, and has been recognized in every bankruptcy statute since the Act of March 2, 1867.<sup>10</sup> In this case, moreover, petitioners are "among the very individuals Congress sought to protect in the securities laws." *Huddleston*, 459 U.S. at 390.

In short, Section 523(a)(2) represents a congressional judgment that certain wrongful conduct by a debtor should *not* be forgiven in bankruptcy. In deciding whether such wrongful conduct has been shown, there is no indication that Congress intended to tip the scales in favor of the debtor and against the victim of fraud. Judicial implication of a standard of proof favoring the

<sup>10</sup> See Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 517; Act of July 1, 1898, ch. 541, § 17, 30 Stat. 550; Act of June 22, 1938, ch. 575, § 17a, 52 Stat. 840. In the 1898 statute, Congress provided that "judgments" sounding in fraud were excepted from discharge. In 1903, Congress substituted the term "liabilities" for "judgments." Act of Feb. 5, 1903, ch. 487, § 5, 32 Stat. 798. As the Court has noted, the 1903 amendment was intended to broaden the category of claims excepted from discharge. *Brown v. Felsen*, 442 U.S. at 138 (quoting H.R. Rep. No. 1698, 57th Cong., 1st Sess. 3, 6 (1902)). In this case, the court of appeals' decision in effect permits some fraud claims to be discharged even if they have been reduced to judgment, a result inconsistent even with the narrow fraud exception of the 1898 statute.

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defrauding debtor would undermine Congress's express policy judgment that the victims of the debtor's fraud should be protected from discharge of the debt owed them by the bankrupt.

**B. A Preponderance Standard of Proof for Proceedings Under Section 523 Is Consistent with Section 727 of the Bankruptcy Code and Important Non-bankruptcy Fraud Statutes**

1. Although the Bankruptcy Code and its legislative history are silent as to the standard of proof in a Section 523(a) proceeding based on fraud, the legislative history of Section 727 of the Code, 11 U.S.C. 727, suggests that Congress intended a preponderance standard to apply under Section 523(a). Section 727 authorizes the bankruptcy court to grant a discharge in a Chapter 7 liquidation proceeding except in certain circumstances. One exceptional circumstance arises where the debtor has engaged in conduct that would operate as a fraud on the bankruptcy court. 11 U.S.C. 727(a)(4).<sup>11</sup> Both the House and the Senate Reports state that "[this] ground for denial of discharge is the commission of a bankruptcy crime, though the standard of proof is preponderance of the evidence rather than proof beyond a reason-

<sup>11</sup> Specifically, Section 727(a)(4) denies the debtor a discharge if:

the debtor knowingly and fraudulently, in or in connection with the case—

- (A) made a false oath or account;
- (B) presented or used a false claim;
- (C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act;
- (D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs.

Section 152, 18 U.S.C., imposes criminal liability on a debtor who engages in the above conduct.

able doubt." H.R. Rep. No. 595, 95th Cong., 1st Sess. 384 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 99 (1978). Congress thus instructed the bankruptcy court to deny a discharge as to *all* debts if it determines, *by a preponderance of the evidence*, that the debtor has committed certain fraudulent acts.<sup>12</sup> Section 523(a) merely excepts from discharge particular debts based on fraudulent conduct. Given that Congress instructed the courts to apply a preponderance standard for fraud under Section 727—when the consequence is total ineligibility for discharge—it is unlikely that Congress would have applied a higher standard of proof under Section 523—when the consequence is simply to except from discharge a particular debt.<sup>13</sup>

2. In the absence of clear congressional direction, this Court has declined to construe the Bankruptcy Code so as to create "an extraordinary exemption from non-bankruptcy law." *United States v. Ron Pair Enterprises, Inc.*, 109 S. Ct. 1026, 1032 (1989) (quoting *Mid-*

<sup>12</sup> Prior to enactment of the Bankruptcy Code, the courts of appeals held that the preponderance standard applied in this context. See, e.g., *In re Robinson*, 506 F.2d 1184, 1187 (2d Cir. 1974); *Union Bank v. Blum*, 460 F.2d 197, 200-201 (9th Cir. 1972). The Code codified this understanding. Remarkably, some bankruptcy courts have refused to give effect to the plain statements in the legislative history or the pre-Code decisions of the courts of appeals. See, e.g., *In re Garcia*, 88 Bankr. 695, 699 (Bankr. E.D. Pa. 1988) (citing cases). These decisions are plainly wrong.

<sup>13</sup> The preponderance standard in Section 727 also belies the notion underlying the decision below that Congress must have legislated against the backdrop of a "prevailing view" that fraud had to be proved by clear and convincing evidence. Section 727—like Section 523—is silent as to the standard of proof, yet Congress plainly intended the preponderance of the evidence standard to apply. See H.R. Rep. No. 595, *supra*, at 384; S. Rep. No. 989, *supra*, at 99. It seems likely that the only reason Congress expressly stated its intent in the legislative history of Section 727 was that the fraud covered by that section is also subject to criminal sanctions under 18 U.S.C. 152, a concern not presented in the same manner with respect to Section 523.

*lantic Nat'l Bank v. New Jersey Dep't of Environmental Protection*, 474 U.S. 494, 501 (1986)). Application of the clear and convincing evidence standard in Section 523 proceedings based on fraud would in effect exempt debtors in bankruptcy from important federal non-bankruptcy laws that require proof of fraud only by a preponderance of the evidence. For example, Congress has provided expressly that the preponderance standard shall apply in fraud actions brought by the United States under the False Claims Act. See 31 U.S.C. 3731(c). Similarly, Congress enacted FIRREA in 1989, Pub. L. No. 101-73, 103 Stat. 183, in part "[t]o strengthen the \* \* \* penalties for defrauding or otherwise damaging [financial] institutions and their depositors." Joint Explanatory Statement of the Committee of Conference, 135 Cong. Rec. H5172, H5174 (daily ed. Aug. 4, 1989); see 12 U.S.C. 1818(i) (expanding civil penalties for bank fraud); 12 U.S.C. 1833a(e) (expressly providing that preponderance standard applies to civil actions brought by the Attorney General to recover civil penalties for certain fraudulent conduct involving financial institutions). The FDIC obtains judgments for civil fraud against persons who defraud banks or thrift institutions under a variety of provisions; including the money penalty provisions of the FDIA, 12 U.S.C. 1818(i), 1821(k)-(l), the securities laws, the civil provisions of the RICO statute, and the antifraud provisions of the Commodity Exchange Act (CEA). Claims under each of these provisions generally are subject to proof by a preponderance of the evidence.<sup>14</sup> In addition, this Court has held that the preponderance standard applies in cases, such as the prior litigation at issue here, brought under Section 10(b) of the Securities Exchange Act and Com-

<sup>14</sup> See *United States v. Local 580, Int'l Bhd. of Teamsters*, 780 F.2d 267, 279 n.12 (3d Cir. 1986) (RICO); *First Nat'l Monetary Corp. v. Weinberger*, 819 F.2d 1334, 1340 (6th Cir. 1987) (CEA). In addition, the FDIC pursues state law remedies for fraud in states that require proof of common law fraud only by a preponderance of the evidence.

mission Rule 10b-5, *Herman & MacLean v. Huddleston*, *supra*.<sup>15</sup>

The clear and convincing evidence standard, if adopted by this Court, would require fraud victims who have successfully litigated fraud claims under the preponderance standard prescribed for various important antifraud statutes to litigate their claims anew, under a higher standard of proof, in the bankruptcy court. The Court should decline to adopt a standard of proof in discharge exception proceedings that is "in clear conflict with \* \* \* federal laws of great importance." *United States v. Ron Pair Enterprises, Inc.*, 109 S. Ct. at 1033.<sup>16</sup>

<sup>15</sup> Congress has enacted significant additional securities antifraud legislation without disturbing the *Huddleston* holding. See H.R. Rep. No. 355, 98th Cong., 1st Sess. 15-16 (1983) (report accompanying the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-379, 98 Stat. 1264).

<sup>16</sup> Such wasteful relitigation would be minimized by applying a preponderance standard in Section 523(a) proceedings. If the creditor has obtained a judgment for fraud in a prior proceeding, under either the preponderance standard or the clear and convincing standard, relitigation in the bankruptcy court will be barred by principles of collateral estoppel so long as the identical issues were actually and necessarily determined in the prior litigation. If the plaintiff has litigated and lost a fraud claim in a prior proceeding, under either standard of proof, relitigation would not be permitted in the bankruptcy court. This is so because Section 523 does not provide a substantive cause of action for fraud. The fraud victim's claim must arise out of federal securities law, state common law, or some other nonbankruptcy source of law with its own standard of proof. If the plaintiff has failed to establish a right to recover in the prior litigation, there is no debt to be excepted from discharge. See *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 161 (1946) (whether "claims of creditors are valid and subsisting obligations against the bankrupt" is generally determined by reference to state law).

## II. APPLICATION OF THE CLEAR AND CONVINCING EVIDENCE STANDARD TO THE FRAUD EXCEPTION TO DISCHARGE WAS NOT A WELL-ESTABLISHED PRE-CODE BANKRUPTCY PRACTICE

In construing the Bankruptcy Code, this Court has said that, absent clear direction from Congress, it will look to well-established judicial interpretations under prior bankruptcy law. See *Pennsylvania v. Davenport*, 110 S. Ct. 2126, 2133 (1990); *Kelly v. Robinson*, 479 U.S. 36, 47 (1986); *Midlantic Nat'l Bank v. New Jersey Dep't of Environmental Protection*, 474 U.S. 494 (1986). In this case, the court of appeals presumed that Congress was aware at the time of enacting Section 523 that the "prevailing view" was that fraud had to be proved by clear and convincing evidence in both discharge exception proceedings and common law actions for damages. Pet. App. 13a. The fundamental difficulty with the court's analysis is that there was no established judicial practice of requiring that fraud exceptions to discharge be proved by clear and convincing evidence. In fact, the courts were and are divided over the standard of proof applicable in civil fraud actions generally, and in bankruptcy exception proceedings in particular. What is more, there is no indication that Congress was made aware of judicial decisions articulating the pertinent standard of proof, or focused on this issue at all.<sup>17</sup>

<sup>17</sup> In addition, a clear and convincing standard for fraud could lead to application of different standards of proof to the various exceptions to discharge enumerated in Section 523(a). Several of the ten categories of excepted debts set out in Section 523(a) are unrelated to fraud. See, e.g., 11 U.S.C. 523(a)(1)(A)-(B) (certain tax liabilities), 523(a)(5) (alimony and child support), 523(a)(6) (certain educational loans), 523(a)(9) (judgment or consent decree for driving while intoxicated). There is no indication that Congress intended some excepted debts to be treated less favorably than others. Consequently, the Court should hesitate to require that some

## A. The Standard of Proof Applicable to Fraud Exceptions to Discharge Was Not Well-Established Prior to 1978

1. Prior to 1970, the bankruptcy courts shared with the state courts concurrent jurisdiction to determine whether a debt was excepted from discharge because it arose from the debtor's fraudulent conduct. As a matter of practice, however, the bankruptcy courts generally did not decide whether particular debts were excepted from discharge. See 1A J. Moore, J. Mulder & L. King, *Collier on Bankruptcy* ¶ 17.28, at 1726-1727 (14th ed. 1978). Instead, the dischargeability question typically was litigated in the state courts, in one of two situations. First, a creditor who had obtained a fraud judgment prior to the bankruptcy proceeding might seek to enforce the judgment in state court after the debtor received a discharge. The debtor would then invoke the discharge as a defense to the enforcement action. See, e.g., *First-Citizens Bank & Trust Co. v. Parker*, 232 N.C. 512, 61 S.E.2d 441 (1950); *Morris v. Levin*, 302 Ill. App. 173, 23 N.E.2d 779 (1939). Second, the creditor might wait until after the debtor emerged from bankruptcy to sue for fraud. Again, the debtor would invoke his discharge as a defense to that action. See, e.g., *Atlas Credit Corp. v. Miller*, 216 So. 2d 100 (La. Ct. App. 1968); *Household Finance Corp. v. Altenberg*, 5 Ohio St. 2d 190, 214 N.E.2d 667 (1966). In both situations, a significant

exceptions be proved by clear and convincing evidence while others require proof only by a preponderance of the evidence.

Indeed, a clear and convincing standard for fraud might lead to application of different standards of proof under Section 523(a)(2). That provision excepts from discharge not only debts incurred through fraud, but debts incurred as a result of "false pretenses, a false representation, or actual fraud." (Emphasis supplied). The most natural interpretation of this disjunctive language is that Section 523(a)(2) excepts certain debts in addition to those incurred as a result of "actual fraud." Thus, cases considering the standard of proof applicable to allegations of actual fraud may not apply to all excepted debts under Section 523(a)(2).

number of courts—often simply applying the standard of proof applicable in the underlying state cause of action to the defense of discharge—required the creditor to prove fraud only by a preponderance of the evidence. See, e.g., *Sweet v. Ritter Finance Co.*, 263 F. Supp. 540, 543 (W.D. Va. 1967); *Nickel Plate Cloverleaf Federal Credit Union v. White*, 120 Ill. App. 2d 91, 92-94, 256 N.E.2d 119, 120-121 (1970); *Gonzales v. Aetna Finance Co.*, 86 Nev. 271, 468 P.2d 15 (1970); *Beneficial Finance Co. v. Machie*, 6 Conn. Cir. Ct. 37, 40-41, 263 A.2d 707, 710 (1969); *Budget Finance Plan v. Haner*, 92 Idaho 56, 59, 436 P.2d 722, 725 (1968); *Mac Finance Plan, Inc. v. Stone*, 106 N.H. 517, 521-522, 214 A.2d 878, 882 (1965); *Atlas Credit Corp. v. Miller*, *supra*; *Household Finance Corp. v. Altenberg*, *supra*.<sup>18</sup> See also *Ames v. Moir*, 138 U.S. 306, 312 (1891) (affirming determination that a debt was excepted from discharge under the 1867 Bankruptcy Act where jury was instructed that it could find fraud by a preponderance of the evidence under state law).<sup>19</sup> Those courts that applied a clear and

<sup>18</sup> Applying the standard of proof applicable to the underlying cause of action for fraud was consistent with the theory that a discharge did not extinguish the debt, but merely provided a defense to the enforcement of the debt. See 1A J. Moore, J. Mulder & L. King, *Collier on Bankruptcy* ¶ 17.27, at 1719 (14th ed. 1978); see also J. Moore & E. Levi, *Gilbert's Collier on Bankruptcy* ¶ 572, at 382-383 (4th ed. 1937) (discussing pleading requirements for asserting discharge as a defense).

<sup>19</sup> In *Oriel v. Russell*, 278 U.S. 358, 362-364 (1929), the Court held that a bankruptcy trustee's right to a "turnover" order must be established by clear and convincing evidence. The Court observed that a charge of failure to turn over property was "equivalent to one of fraud" (*id.* at 362), but the Court's decision rested primarily on the fact that "the [turnover] proceeding is one in which coercive methods by imprisonment [for civil contempt] are probable and are foreshadowed." *Id.* at 363. The Court observed that, in the context of a turnover order, a heightened standard of proof would prevent delays caused by "efforts on the part of bankrupts to retry the issue presented on the motion to turn over." *Ibid.* In the context

convincing standard of proof often did so because the heightened standard applied in that state to proof of fraud in the first instance. See, e.g., *Tek-Ni-Kal Employees Credit Union v. Atkins*, 12 Mich. App. 1, 4, 162 N.W.2d 299, 300 (1968); *Household Finance Corp. v. Williams*, 66 Wash. 2d 183, 185, 401 P.2d 876, 877 (1965); *First Nat'l Bank v. Scieszinski*, 25 Wis. 2d 569, 572, 131 N.W.2d 308, 310 (1964).

2. In 1970, Congress amended the Bankruptcy Act to give the bankruptcy courts exclusive jurisdiction over the dischargeability of certain debts, including debts arising from fraud. Following the 1970 amendments, some federal courts applied the preponderance standard to such claims, see, e.g., *Fierman v. Lazarus*, 361 F. Supp. 477, 480 (E.D. Pa. 1973); *In re Scott*, 1 Bankr. Ct. Dec. (CRR) 581, 583 (Bankr. W.D. Mich. 1975), while others applied the clear and convincing evidence standard of proof, see, e.g., *Brown v. Buchanan*, 419 F. Supp. 199 (E.D. Va. 1975); *In re Arden*, 75 Bankr. 707, 710-711 (Bankr. D.R.I. 1975). Thus, there was no established and consistent practice among courts regarding the standard of proof applied in discharge exception proceedings that Congress could be said to have ratified *sub silentio* in enacting Section 523 in 1978.

Here, no evidence exists that Congress was made aware of any judicial decisions discussing what standard of proof to apply in discharge exception proceedings, let alone decisions applying a clear and convincing standard. And, as set out above, the law as to what standard applied was far from clear. Thus, the court of appeals' "presum[ption]"—based on congressional silence, Pet. App. 13a—was wholly unwarranted.

of Section 523, however, the typical preponderance standard will avoid such delays.

### B. The Courts Are Divided Over the Standard of Proof Applicable to Civil Actions for Fraud

Although this Court has referred to the heightened standard of proof "traditionally" imposed in civil fraud cases, see *Cruzan v. Director, Missouri Dep't of Health*, No. 88-1503 (June 25, 1990) slip op. 18 (quoting *Woodby v. INS*, 385 U.S. at 285 n.18), close examination of the cases reveals that, both before and after the enactment of the Bankruptcy Code in 1978, the courts were deeply divided over the appropriate standard of proof in civil actions for fraud. As early as 1943, this Court applied the preponderance of the evidence standard in a civil fraud action under the securities laws. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943) (15 U.S.C. 77q(a)). In addition, both before and after 1978, a significant number of state courts have held that the preponderance standard applies in civil actions for fraud.<sup>20</sup> Moreover, several pre-Code treatises state that

<sup>20</sup> See *Saxton v. Harris*, 395 P.2d 71, 72 (Alaska 1964); *Sellers v. West-Ark Constr. Co.*, 283 Ark. 341, 343-344, 676 S.W.2d 726, 728 (1984) (preponderance standard in cases tried to a jury; clear and convincing proof needed to cancel or reform a writing in equity); *Clay v. Brand*, 236 Ark. 236, 242-243, 365 S.W.2d 256, 259-260 (1963); *Liodas v. Sahadi*, 19 Cal. 3d 278, 289-290, 562 P.2d 316, 320-324, 137 Cal. Rept. 635, 641-642 (1977); *Kern v. NCD Indus., Inc.*, 316 A.2d 576, 582 (Del. Ch. 1973); *Nye Odorless Incinerator Corp. v. Felton*, 35 Del. 236, 162 A. 504 (1932); *Watson Realty Corp. v. Quinn*, 452 So. 2d 568, 569 (Fla. 1984); *Rigot v. Bucci*, 245 So. 2d 51, 53 (Fla. 1971); *City Dodge, Inc. v. Gardner*, 232 Ga. 766, 770, 208 S.E. 2d 794, 798 (1974); *Milligan v. Milligan*, 209 Ga. 743, 744, 76 S.E.2d 18, 19 (1953) (fraud "being in itself subtle, slight circumstances may be sufficient to carry conviction of its existence"); *Grissom v. Moran*, 154 Ind. App. 419, 427, 290 N.E.2d 119, 123 (1972); *LaCaze v. Louisiana*, 541 So. 2d 322, 328 (La. Ct. App. 1989); *Atlas Credit Corp. v. Miller*, 216 So. 2d 100, 101 (La. Ct. App. 1968); La. Civ. Code Ann. art. 1957 (West 1987); *Martin v. Guarantee Reserve Life Ins. Co.*, 279 Minn. 129, 137-138, 155 N.W.2d 744, 749 (1968); *Cowan v. Westland Realty Co.*, 162 Mont. 379, 382-383, 512 P.2d 714, 716 (1973); *Tobin v. Flynn & Larsen Implement Co.*,

the preponderance standard applies to many or most civil proceedings involving allegations of fraud.<sup>21</sup> It is

220 Neb. 259, 262-263, 369 N.W.2d 96, 99 (1985) (preponderance standard applies in actions at law for damages); *Murphy Fin. Co. v. Fredericks*, 177 Neb. 1, 4-5, 127 N.W.2d 924, 926 (1964) (same); *Fischetto Paper Mill Supply, Inc. v. Quigly Co.*, 3 N.J. 149, 155, 69 A.2d 318, 321 (1949) (approving "greater weight of the evidence" instruction); *Medivox Productions, Inc. v. Hoffman-LaRoche, Inc.*, 107 N.J. Super. 47, 69, 256 A.2d 803, 814-815 (1969) (preponderance standard applies in legal actions; clear and convincing standard applies in equitable actions); *Maynard v. Durham & Southern Ry.*, 251 N.C. 783, 787-788, 112 S.E.2d 249, 252 (1960), (preponderance of the evidence sufficient to set aside instrument procured by fraud; clear and convincing proof required to reform instrument) rev'd on other grounds, 365 U.S. 160 (1961); *Household Fin. Corp. v. Altenberg*, 5 Ohio St. 2d at 192-194, 34 Ohio Op. 2d at 348-349, 214 N.E.2d at 669-670 (preponderance standard applies to legal actions for fraud; clear and convincing standard applies to equitable actions); *Ostalkiewicz v. Guardian Alarm*, 520 A.2d 563, 569 (R.I. 1987); *Smith v. Rhode Island Co.*, 39 R.I. 146, 153-154, 98 A. 1, 4 (1916); *General Electric Credit Corp. v. M.D. Aircraft Sales, Inc.*, 266 N.W.2d 548, 550 (S.D. 1978); *Aschoff v. Mobil Oil Corp.*, 261 N.W.2d 120, 125 (S.D. 1977); *Piccadilly Square v. Intercontinental Constr. Co.*, 782 S.W.2d 178, 184 (Tenn. App. 1989); *James v. Joseph*, 156 Tenn. 417, 424, 1 S.W. 2d 1017 (1928); *Wirtz v. Orr*, 575 S.W.2d 66, 70-71 (Tex. Civ. App. 1978); *Wyatt v. Chambers*, 182 S.W. 16, 18 (Tex. Civ. App. 1915). Cf. *Travelers Indem. Co. v. Armstrong*, 442 N.E.2d 349, 361 (Ind. 1982) (clear and convincing evidence required to obtain punitive damages for fraud).

Illinois appears to have required proof of fraud only by a preponderance of the evidence until 1983, although thereafter it has required clear and convincing proof. See *L & S Enterprises Co. v. Great American Ins. Co.*, 454 F.2d 457, 460 (7th Cir. 1971) (preponderance); *Barrett v. Shanks*, 382 Ill. 434, 47 N.E.2d 481 (1943) (same); *Hofmann v. Hofmann*, 94 Ill. 2d 205, 222, 446 N.E. 2d 499, 506 (1983) (clear and convincing).

<sup>21</sup> See, e.g., 37 Am. Jur. 2d *Fraud and Deceit* § 468 (1968); 37 C.J.S. *Fraud* § 94, 113 (1943); Annotation, *Quantum of Proof in Civil Case on Issue Involving Fraudulent, Dishonest, or Criminal Misappropriation of Property*, 62 A.L.R. 1449 (1929); 2 T. Cooley, *Treatise on the Law of Torts* § 349, at 552-554 (4th ed. 1932); M. Bigelow, *The Law of Fraud and the Procedure Pertaining to the Redress Thereof* 474 (1877).

true that a majority of the States require that fraud be proved by more than a preponderance of the evidence, but the majority is far from overwhelming.<sup>22</sup> Even in these States, moreover, courts sometimes apply a preponderance standard.<sup>23</sup> In other cases, the court's formula-

<sup>22</sup> See *D.H. Holmes Dep't Store v. Feil*, 472 So. 2d 1001 (Ala. 1985); *Rhoads v. Harvey Publications, Inc.*, 145 Ariz. 142, 700 P.2d 840 (1984); *Ficor, Inc. v. McHugh*, 639 P.2d 385 (Colo. 1982); *Miller v. Appleby*, 183 Conn. 51, 55, 438 A.2d 811, 813 (1981) ("clear and satisfactory evidence"); *Pyne v. Jamaica Nutrition Holdings, Ltd.*, 497 A.2d 118 (D.C. 1985); *Dobison v. Bank of Hawaii*, 60 Haw. 225, 587 P.2d 1234 (1978); *Magic Valley Potato Shippers v. Continental Ins.*, 112 Idaho 1073, 739 P.2d 372 (1987); *Beeck v. Aquaslide 'N' Dive Corp.*, 350 N.W.2d 149, 155 (Iowa 1984) ("preponderance of clear, satisfactory, and convincing evidence"); *Stauth v. Brown*, 241 Kan. 1, 734 P.2d 1063 (1987); *Sanford Constr. Co. v. S & H Contractors, Inc.*, 443 S.W.2d 227 (Ky. 1969); *Butler v. Poulin*, 500 A.2d 257 (Me. 1985); *Peurifoy v. Congressional Motors, Inc.*, 254 Md. 501, 255 A.2d 332 (1969); *Transitron Elec. Corp. v. Hughes Aircraft Co.*, 649 F.2d 871 (1st Cir. 1981) (Massachusetts law); *Hi-Way Motor Co. v. International Harvester Co.*, 398 Mich. 330, 247 N.W.2d 813 (1976); *Tietjens v. General Motors Corp.*, 418 S.W.2d 75 (Mo. 1967); *Lubbe v. Barba*, 91 Nev. 596, 540 P.2d 115 (1975); *Caledonia, Inc. v. Trainor*, 123 N.H. 116, 459 A.2d 613 (1983); *Snell v. Cornehl*, 81 N.M. 248, 466 P.2d 94 (1970); *Simcusi v. Saeli*, 44 N.Y.2d 442, 377 N.E. 713, 406 N.Y.S. 2d 259 (1978); *Buehner v. Hoeven*, 228 N.W.2d 893 (N.D. 1975); *Tice v. Tice*, 672 P.2d 1168, 1171 (Okla. 1983); *Bausch v. Myers*, 273 Or. 376, 541 P.2d 817 (1975); *Yoo Hoo Bottling Co. v. Leibowitz*, 432 Pa. 117, 247 A.2d 469 (1965); *Davis v. Upton*, 250 S.C. 288, 157 S.E.2d 567 (1967); *Schwartz v. Tanner*, 576 P.2d 873 (Utah 1978); *Bardill Land & Lumber, Inc. v. Davis*, 135 Vt. 81, 370 A.2d 212 (1977); *Gibson v. Gibson*, 207 Va. 821, 153 S.E.2d 189 (1967); *Beckett v. Department of Social & Health Serv.*, 87 Wash. 2d 184, 550 P.2d 529, 531 (1976); *Campbell v. Campbell*, 146 W. Va. 1002, 124 S.E.2d 345, 353 (1962) ("clear and distinct proof"); *Miles v. Mackle Bros.*, 73 Wis. 2d 84, 242 N.W.2d 247 (1976); *Duffy v. Brown*, 708 P.2d 433 (Wyo. 1985).

<sup>23</sup> See, e.g., *Kopeikin v. Merchants Mortgage & Trust Corp.*, 679 P.2d 599, 601 (Colo. 1984) (en banc) (fraudulent concealment); *Goodfellow v. Kattinig*, 533 P.2d 58, 60 (Colo. Ct. App. 1975); *Modern Displays, Inc. v. Hennecke*, 350 Mich. 67, 85 N.W.2d 80

tion of the standard of proof is so confusing that it is difficult to know what standard it applied.<sup>24</sup>

In short, both the state courts and the bankruptcy courts were divided over the appropriate standard of proof in fraud exception proceedings, as well as in civil actions for fraud. Accordingly, there is no reason to conclude on the basis of Congress's silence that it was implicitly ratifying a well-established practice of requiring proof of fraud in discharge exception proceedings by clear and convincing evidence. There simply was no such well-established practice.

### C. The Reasons for Requiring Clear and Convincing Proof in Certain Fraud Actions are Inapplicable in Section 523 Proceedings

As this Court has recognized, the practice of requiring a heightened standard of proof in certain civil proceedings involving fraud appears to have arisen in actions in which a court of equity was requested to grant relief on claims that were unenforceable at law for failure to comply with the Statute of Frauds, the Statute of Wills, or the parol evidence rule. See *Herman & MacLean v. Huddleston*, 459 U.S. at 388 n.27. A higher standard of proof subsequently was applied in actions seeking to set aside or alter the terms of written instruments. The heightened proof requirement was employed in such

(1957); *Goodrich v. Waller*, 314 Mich. 456, 22 N.W.2d 862 (1946); *In re Delligan's Estate*, 111 Vt. 227, 234-235, 13 A.2d 282, 287 (1940).

<sup>24</sup> See, e.g., *Arnett v. Sanderson*, 25 Ariz. 433, 444, 218 P. 986, 990 (1923) ("It is true that proof of fraud should be clear and convincing, but this does not mean that the clear and convincing proof is not to be by a preponderance of the evidence; in fact, fraud is determined by a preponderance of the evidence."); *Gilbert v. Mid-South Machinery Co.*, 267 S.C. 211, 222-223, 227 S.E.2d 189, 194 (1976) ("Fraud must be established by a preponderance of the evidence \* \* \* and, while the evidence must be clear and convincing, such clear and convincing proof may be met by a preponderance of the evidence.") (quoting 37 C.J.S. *Fraud* § 114a (1943)).

cases because they were believed to involve special dangers that claims might be fabricated. *Ibid.* (citing Note, *Appellate Review in the Federal Courts of Findings Requiring More than a Preponderance of the Evidence*, 60 Harv. L. Rev. 111, 112 (1946)). In these cases, the courts were concerned to protect the validity of written instruments and the reliance placed upon such documents.<sup>25</sup>

The reasons for requiring proof by clear and convincing evidence have little relevance in proceedings to except a debt from discharge under the Bankruptcy Code. In many cases, including this one, the validity of a written instrument is not at issue. In addition, many important federal antifraud provisions "are not coextensive with common-law doctrines of fraud." *Huddleston*, 459 U.S. at 388-389. In fact, as the Court observed in *Huddleston*, statutory remedies for fraud were enacted precisely because of the shortcomings of common law fraud remedies. *Id.* at 389. Accordingly, arguments based on the common law of fraud have little application in the context of a bankruptcy proceeding under Section 523(a).

<sup>25</sup> The Court noted this history in *Cruzan v. Director, Missouri Dep't of Health*, No. 88-1503 (June 25, 1990), slip op. 18, and has applied a heightened standard of proof to protect the integrity of formal documents in earlier cases. See *United States v. American Bell Tel. Co.*, 167 U.S. 224 (1897) (suit to set aside a patent); *Southern Dev. Co. v. Silva*, 125 U.S. 247 (1888) (suit to rescind a land purchase contract).

## CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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**In the Supreme Court of the United States**  
**OCTOBER TERM, 1990**

**COY R. GOGAN, ET AL., PETITIONERS,**

**v.**

**FRANK J. GARNER, JR., RESPONDENT.**

**ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE EIGHTH CIRCUIT**

**BRIEF FOR THE RESPONDENT**

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**BEST AVAILABLE COPY**

## QUESTION PRESENTED

1. What burden of proof applies to the exception from discharge under Section 523(a)(2) of the Bankruptcy Code for debts arising from "false pretenses, a false representation, or actual fraud": preponderance of the evidence or clear and convincing evidence?

### I. THE CLEAR AND CONVINCING EVIDENCE STANDARD OF PROOF APPLIES IN ACTIONS UNDER SECTION 523(a)(2) OF THE BANKRUPTCY CODE TO EXCEPT FROM DISCHARGE DEBTS INCURRED BY FRAUD

#### A. The Clear and Convincing Evidence Standard Generally Applies to Cases Alleging Civil Fraud

#### B. The "Fresh Start" Doctrine Compels Application of the Clear and Convincing Evidence Standard in Section 523(a)(2) Proceedings

#### C. Interpretation of Other Provisions of the Bankruptcy Code is Consistent With Application of the Clear and Convincing Standard in Section 523(a)(2) Proceedings

#### A PRIOR CIVIL JUDGMENT OF FRAUD BASED UPON A PREPONDERANCE STANDARD OF PROOF DOES NOT COLLATERALLY ESTOP LITIGATION IN FRAUD ISSUES IN A SECTION 523(a)(2) PROCEEDING

### CONCLUSION

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ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

STATEMENT OF THE CASE

On May 5, 1965, the United States District Court for the Western District of Missouri entered judgment on a jury verdict in favor of Petitioner, Coy R. Grogan and John H. Grogan, and against Respondent, Frank J. Grogan, Jr., an officer of Columbia Gas Transmission Corporation, for damages under the Securities Exchange Act of 1934, 15 U.S.C. § 78j. The jury awarded Respondent \$249,000 actual damages, and to the petitioners the same plus \$24,900 punitive damages. The United States Court of Appeals affirmed the judgment but reduced the amount of damages. Appendix To Petition For Writ of Certiorari ("App. Pet.") 3a.

A general opinion of the court was filed on the petition for appeal from the bankruptcy court, but the United States District Court "expressly" held that the standard of review under the Securities Exchange Act of 1934 was not applicable. App. Pet. 2a. The trial court also instructed the jury that damages could not

# In the Supreme Court of the United States

OCTOBER TERM, 1990

No. 89-1149

COY R. GROGAN, et al., *Petitioners*,

v.

FRANK J. GARNER, JR., *Respondent*.

## ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

### BRIEF FOR THE RESPONDENT

#### STATEMENT OF THE CASE

On May 8, 1985, the United States District Court for the Western District of Missouri entered judgment on a jury verdict in favor of Petitioners, Coy R. Grogan and John H. Henson, and against Respondent, Frank J. Garner, Jr., on claims of common law fraud, breach of fiduciary duty and violation of the Securities Exchange Act of 1934. J.A. 28-31. The jury awarded Petitioners \$249,000 actual damages, and on the common law fraud claim, \$24,900 punitive damages. The United States Court of Appeals affirmed the judgment but reduced the amount of damages. Appendix To Petition For Writ of Certiorari ("App. Pet.") 3a.

A general burden of proof instruction was not in the record on appeal from the bankruptcy court, but the United States District Court "assume[d] . . . that the standard [Missouri] burden of proof instruction was used. . . ." App. Pet. 23a-24a. The trial court also instructed the jury that damages could not

be based on speculation; Petitioners had the burden of proving their damages by a "preponderance of the evidence." J.A. 46-47, 58.

On October 21, 1985, Respondent filed a petition for relief under Chapter 11 of the Bankruptcy Code, listing Petitioners' judgment as a dischargeable debt. Petitioners thereafter filed an adversary proceeding under 11 U.S.C. § 523(a) to except the debt from discharge. App. Pet. 3a-4a, J.A. 3-4. At the hearing on their Complaint, Petitioners called no witnesses. Instead, they offered in evidence four exhibits: (1) Petitioners' First Amended Complaint from the prior civil action, (2) an Addendum from the Brief of Appellant Garner to the United States Court of Appeals for the Eighth Circuit which included copies of the prior judgments, post-trial orders and various jury instructions, (3) the opinion of the Eighth Circuit affirming the judgment, and (4) a letter from the clerk of the court transmitting the Eighth Circuit's opinion. J.A. 7-10, 16-87. Petitioners did not offer a transcript of the prior fraud trial. Nor was there any stipulation by the parties that the witnesses in the prior trial, if called in the bankruptcy proceeding, would testify as they had previously. App. Pet. 31a.

Respondent moved for a directed verdict, arguing that Petitioners must prove the nondischargeability of a debt under section 523(a)(2) by clear and convincing evidence, not a mere preponderance. Accordingly, Respondent urged, the judgment from the prior fraud trial did not have collateral estoppel effect on the issue of whether the debt was dischargeable in bankruptcy, because of the differing burdens of proof. The court denied Respondent's motion. J.A. 10-12. Respondent then testified briefly, denying he ever had made any false statements or misrepresentations to Petitioners. J.A. 12-14.

The bankruptcy court concluded that collateral estoppel applied and that Petitioners had sustained their burden of establishing that the debt was not dischargeable under section 523(a)(2) of the Bankruptcy Code. App. Pet. 30a-41a. In denying Respondent's motion to alter or amend the judgment, the bankruptcy court declared that the "clear and convincing" stan-

dard was not a higher standard of proof than "preponderance of the evidence". J.A. 88-89.

The United States District Court for the Western District of Missouri affirmed the bankruptcy court's order. App. Pet. 16a-29a. Thereafter, the United States Court of Appeals for the Eighth Circuit reversed, holding that the bankruptcy court had erred in giving collateral estoppel effect to the prior fraud judgment because the jury verdict in that case was based on a preponderance of the evidence, whereas fraud under section 523 of the Bankruptcy Code must be established by clear and convincing evidence. App. Pet. 1a-15a.

## SUMMARY OF ARGUMENT

A claim that a debt arises from "false pretenses, a false representation, or actual fraud," and thus is excepted from discharge under section 523(a)(2) of the Bankruptcy Code, must be proved by clear and convincing evidence. When Congress enacted the Bankruptcy Reform Act of 1978, it did not prescribe what standard of proof should apply to determine whether a claim is excepted from discharge. However, when the statute was enacted, as today, the clear majority of states required proof of civil fraud by clear and convincing evidence.

The preponderance of the evidence standard applies in actions seeking merely a money judgment. Fraud cases require a higher standard of proof because of the strong presumption against fraud and bad faith, and to guard against possible fabrication of claims. Contrary to the suggestion of Petitioners and amici, the clear and convincing evidence standard is not limited to actions to reform written instruments or cases involving due process rights. This Court and most others have recognized that fraud must be proved by clear and convincing evidence. In fact, most courts, as well as the leading treatises on the subject, treat this proposition as a virtual truism.

The courts almost universally have applied the clear and convincing standard to actions under section 523(a)(2) of the Bankruptcy Code. In fact, every United States Court of Appeals that has addressed the issue has held that fraud must be proved by clear and convincing evidence before a debt will be excepted from discharge under section 523(a)(2). There is no split of authority on this issue. The circuit courts base their holdings on several factors, including the necessity to overcome the presumption of innocence, the authority of leading bankruptcy treatises, and most importantly, that the exceptions to discharge set forth in section 523(a) must be strictly construed to effectuate the fresh start policy which permeates the Bankruptcy Code and its legislative history.

Petitioners and amici sound an alarm at the prospect of differing standards of proof for different types of non-dischargeable debts under section 523(a). However, these differences always have existed, and they were prevalent when the Code was adopted. In fact, legislative history reveals that Congress was keenly aware that it was grouping various types of potentially non-dischargeable debts under the section 523 umbrella.

Amici also bemoan the unfair burden on the government if it must prove fraud by clear and convincing evidence in section 523(a)(2) discharge proceedings. However, when Congress passed certain anti-fraud statutes imposing on the government only the preponderance standard, Congress must be presumed to have known the alleged inconsistency it was creating. Whatever burden exists was created by Congress; it is not a new concept foisted upon the government by the court of appeals in this case. If the clear and convincing standard imposes too great a burden on the government, the solution is plain and simple: the government can persuade Congress to amend the Bankruptcy Code to specify the preponderance standard, as it has in other federal statutes.

Applying the clear and convincing standard in section 523(a)(2) proceedings also is consistent with judicial interpretations of other Bankruptcy Code provisions that require findings of fraud. Specifically, the courts universally require clear and convincing evidence to establish fraudulent transfers under 11 U.S.C. § 548(a)(1) and to justify the appointment of a trustee in Chapter 11 cases under 11 U.S.C. § 1104.

Applying the clear and convincing standard is not inconsistent with section 727(a)(4) or its legislative history. Courts have rejected the sketchy legislative history of section 727(a)(4) which amici suggest requires application of the preponderance standard under that section and, by analogy, section 523(a)(2). Congress' effort to define "bankruptcy crimes" under section 727 apparently has led to some confusion. However, it is clear that Congress was attempting merely to clarify that bankruptcy crimes need not be proved "beyond a reasonable doubt."

Amici's reading of the legislative history also is inconsistent with the Advisory Committee Notes which state that Bankruptcy Rule 4005 leaves to the courts the evidentiary standard that an objecting creditor must meet in dischargeability proceedings. Finally, the grounds for a complete denial of discharge under section 727 generally involve misconduct or fraud upon all creditors, or upon the court itself, within the confines of the bankruptcy proceeding. Congress may well have intended to prescribe a lower standard of proof under section 727(a)(4) than under section 523(a)(2) because the latter involves fraud with respect to the creation of a debt vis-a-vis one creditor only; it does not involve fraud upon the court or the bankruptcy process.

Application of the clear and convincing standard is consistent with the touchstone of the bankruptcy process: the fresh start policy. Since passage of the 1898 National Bankruptcy Act, this Court and others have noted that one of the primary purposes of the bankruptcy laws is to release the debtor from the burden of certain financial obligations so he or she may have a new economic start in life. Congress enacted the 1970 amendments for the specific purpose of effectuating more fully the discharge in bankruptcy. The legislative history of the Bankruptcy Reform Act of 1978 is laced with evidence that the fresh start policy was carried forward as a centerpiece of the new Bankruptcy Code. As this Court has noted, provisions of the Code are to be construed in harmony with the fresh start policy to effectuate the general purposes of the bankruptcy laws.

This Court has held that collateral estoppel, in the absence of a countervailing statutory policy, may bar relitigation of certain factual issues in bankruptcy courts. The all-encompassing policy of the fresh start is just such a countervailing statutory policy. If collateral estoppel applies at all in section 523(a) proceedings, then appropriate limitations must be prescribed to protect and perpetuate the fresh start policy.

Collateral estoppel does not apply in any event, however, if there are differing burdens of proof. Because the prior civil judgment in this case was based upon a mere preponderance of the evidence, that judgment, and any findings of fact in that

case, can have no collateral estoppel effect in the discharge proceeding.

The promotion of judicial economy by preventing needless litigation certainly is a laudable goal. While appealing on its face, this concept does not trump all other rights and interests. As urged by Petitioners and amici, the interest of judicial economy is inconsistent with the fresh start policy of the Bankruptcy Code. Respondent does not quarrel with the familiar adage that discharge is a privilege granted to the "honest but unfortunate debtor". However, before a debtor is branded as *both* dishonest and unfortunate, and denied a "fresh start in life," creditors should be required to establish fraudulent conduct by clear and convincing evidence. Accordingly, Respondent asks this Court to affirm the judgment of the Court of Appeals.

## ARGUMENT

### I. THE CLEAR AND CONVINCING EVIDENCE STANDARD OF PROOF APPLIES IN ACTIONS UNDER SECTION 523(a)(2) OF THE BANKRUPTCY CODE TO EXCEPT FROM DISCHARGE DEBTS INCURRED BY FRAUD

#### A. The Clear and Convincing Evidence Standard Generally Applies in Cases Alleging Civil Fraud

"Where Congress has not prescribed the appropriate standard of proof and the Constitution does not dictate a particular standard, [the Court] must prescribe one." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983). There are three basic standards of proof: (1) mere preponderance, (2) clear and convincing, and (3) beyond a reasonable doubt.<sup>1</sup> These standards occupy their respective places along a continuum of increasing certainty. *Addington v. Texas*, 441 U.S. 418, 423-24 (1979). The first two are applied in civil cases, while the third is reserved exclusively for criminal cases. *Id.*

Courts apply the preponderance of the evidence standard in typical civil actions for money damages. This standard allocates the risk of error in judgment in roughly equal fashion between the parties. *Huddleston*, 459 U.S. at 390. In a civil suit between two private parties, society's interests are not at stake. In the public's view, it is no more serious for there to be an error in favor of one side than the other. *In re Winship*, 397 U.S. 358, 371 (1970) (Harlan, J., concurring).

<sup>1</sup> "The function of a standard of proof . . . is to 'instruct the factfinder concerning the degree of confidence our society thinks he should have in the correctness of factual conclusions for a particular type of adjudication.'" *Addington v. Texas*, 441 U.S. 418, 423 (1979) (quoting *In re Winship*, 397 U.S. 358, 370 (1970) (Harlan, J., concurring)); see also *Cruzan v. Director, Missouri Dep't of Health*, 58 U.S. L.W. 4916, 4921 (U.S. June 25, 1990) (No. 88-1503).

In a discharge proceeding under 11 U.S.C. § 523(a)(2), however, more is at stake than a mere money judgment. At stake is an adjudication of fraud, which traditionally must be established by *more* than a mere preponderance of the evidence.<sup>2</sup> Because proof of fraud under section 523(a)(2) would deny Respondent a discharge and override the fresh start policy of the Bankruptcy Code, Petitioners should be required to meet a higher evidentiary standard.

The clear and convincing standard originated in the courts of equity and was applied to claims that were "shown to be inherently subject to fabrication, lapse of memory, or the flexibility of conscience." Note, *Appellate Review in the Federal Courts of Findings Requiring More Than a Preponderance of the Evidence*, 60 Harv. L. Rev. 111, 112 (1946). Today, this "intermediate" standard "is no stranger to the civil law." *Woodby v. INS*, 385 U.S. 276, 285 (1966). "The [clear and convincing] standard, or an even higher one, has traditionally been imposed in cases involving allegations of civil fraud, and in a variety of other kinds of civil cases . . ." *Id.* at 285 n.18 (emphasis added) (citing 9 Wigmore, Evidence § 2498 (3d ed. 1940)).

<sup>2</sup> However, the burden of proof instruction given by the federal court in the prior civil action in this case appears to be Missouri Approved Instruction ("M.A.I.") No. 3.01. App. Pet. 23a-24a. The drafters of the M.A.I. intended for Instruction No. 3.01, the general burden of proof instruction, to be a jury-friendly way of requiring "preponderance of the evidence" or "the greater weight of the evidence." 1963 Report to Missouri Supreme Court, *Missouri Approved Instructions* (3d ed.).

See also *Cruzan v. Director, Missouri Dep't of Health*, 58 U.S.L.W. 4916, 4921 (U.S. June 25, 1990) (No. 88-1503).<sup>3</sup>

The clear and convincing standard is applied when there is more at stake than mere loss of money. *Santosky v. Kramer*, 455 U.S. 745, 756 (1982) (quoting *Addington*, 441 U.S. at 424). While this standard regularly has been applied in actions to reform or annul written instruments on the grounds of fraud, it is not limited to those types of cases.<sup>4</sup> Rather, the clear and convincing standard has been applied in many equity contexts. See generally 9 Wigmore, *Evidence* § 2498 (Chadbourn rev. 1981); 30 Am. Jur. 2d *Evidence* § 1167 (1967); 32A C.J.S.

<sup>3</sup> A leading treatise on the law of evidence concurs:

While . . . the traditional measure of persuasion in civil cases is by a preponderance of evidence, there is a limited range of claims and contentions which the party is required to establish by a more exacting measure of persuasion. The formula varies from state to state, but among the phrases used are the following: "By clear and convincing evidence," "clear, convincing and satisfactory," "clear, cogent and convincing," and "clear, unequivocal, satisfactory and convincing."

Among the classes of cases to which this special standard of persuasion has been applied are the following: (1) charges of fraud and undue influence, . . . (4) proceedings to set aside, reform or modify written transactions or official acts on grounds of fraud, mistake or incompleteness, and (5) miscellaneous types of claims and defenses . . . where there is thought to be special danger of deception . . .

E. Cleary, *McCormick On Evidence* § 340, at 959-61 (3d ed. 1984) (emphasis added) (footnotes omitted).

<sup>4</sup> Several courts state that the clear and convincing standard is applicable "especially" (but not exclusively) where the complaining party is moving to set aside a written instrument. See, e.g., *Weise v. Red Owl Stores*, 286 Minn. 199, 175 N.W.2d 184 (1970); *Gillingham v. Stadler*, 93 Idaho 874, 477 P.2d 497 (1970).

*Evidence* § 1253 (1964); Pomeroy, *Equity Jurisprudence* § 859a (1941).<sup>5</sup>

The Legislative Statements to 11 U.S.C. § 523(a)(2) recite that there is no indication of any Congressional intent to incorporate into section 523(a)(2) a definition of "fraud" other than that used at common law. Thus, the historical treatment of common law fraud claims is crucial to a determination of the appropriate burden of proof in this case. "Where the language of the statute is subject to reasonable doubt, reference to common law principles may provide a valuable clue . . . . Legislation must be interpreted in light of the common law and the scheme of jurisprudence existing at the time of its enactment." 2A Singer, *Sutherland Statutory Construction* § 50.01 (4th ed. 1984) (citing *Isbrandtsen Co. v. Johnson*, 343 U.S. 779 (1952)). See also *United States v. Sanges*, 144 U.S. 310 (1892). The Court presumes that Congress intended to maintain continuity between pre-Code judicial practice and the enactment of

<sup>5</sup> The clear and convincing standard has been required to prove charges of fraud or undue influence, *Barr Rubber Co. v. Sun Rubber Co.*, 425 F.2d 1114, 1120 (2d Cir. 1970); to prove the existence and contents of a lost deed or will, *Slaughter v. Cornie Slave Co.*, 291 S.W. 69, 71 (Ark. 1927); to prove a parole gift or agreement to bequeath or devise by will, *Estate of Passman*, 537 S.W.2d 380, 384 (Mo. 1976); to prove mutual mistake sufficient to reform a written instrument, *Philippine Sugar Estates Dev. Co. v. Philippine Islands*, 247 U.S. 385, 391 (1917); to prove a parole or constructive trust, *Harris v. Gurley*, 80 F.2d 744, 748 (5th Cir. 1936); to cancel a contract, *Atlantic Delaine Co. v. James*, 94 U.S. 207 (1876); to prove an oral contract as a basis for specific performance, *Boyers v. Boyers*, 147 S.W.2d 473 (Mo. 1941); and to show prior anticipatory use of an invention, *Haggerty v. Rawlings Mfg. Co.*, 14 F.2d 928, 929 (8th Cir. 1926). Treatises identify many other situations in which clear and convincing proof has been required, including: proof of a principal's ratification of the unauthorized act of an agent; showing a deed absolute on its face to be a mortgage; and to prove facts relied upon in support of estoppel. See 30 Am. Jur. 2d *Evidence* § 1167 (1967). The Court also has applied the clear and convincing standard to certain defamation actions. *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 331-32 (1974). The same standard applies where constitutional considerations of due process and individual rights are implicated. The Court thus has required clear and convincing evidence in the context of civil commitment proceedings, *Addington v. Texas*, 441 U.S. 418 (1979); deportation, *Woodby v. INS*, 385 U.S. 276 (1966); termination of parental rights, *Santosky v. Kramer*, 455 U.S. 745 (1982); and denaturalization, *Chaunt v. United States*, 364 U.S. 350 (1960).

the Bankruptcy Code in 1978, *Midatlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection*, 474 U.S. 494, 501 (1986); and Congress is presumed to know the existing law at the time of the enactment of a statute. *Cannon v. University of Chicago*, 441 U.S. 677, 696-97 (1979); see also *Goodyear Atomic Corp. v. Miller*, 486 U.S. 174, 184-85 (1988); *Abernaz v. United States*, 450 U.S. 333, 341-42 (1981).

At the time of the enactment of the Bankruptcy Code in 1978, a significant majority of states required that fraud be proved by something more than a preponderance of the evidence, typically by clear and convincing evidence.<sup>6</sup> The same

<sup>6</sup> *Klinger v. Hummel*, 11 Ariz. App. 356, 464 P.2d 676 (1970); *Busker v. United Illuminating Co.*, 156 Conn. 456, 242 A.2d 708 (1968) ("clear, precise & unequivocal"); *Dobison v. Bank of Hawaii*, 60 Haw. 225, 587 P.2d 1234 (1978); *Gillingham v. Stadler*, 93 Idaho 874, 477 P.2d 497 (1970); *Ray v. Winter*, 67 Ill.2d 296, 367 N.E.2d 678 (1977); *Hall v. Wright*, 261 Iowa 758, 156 N.W.2d 661 (1968) ("preponderance that is clear, satisfactory and convincing"); *Sanford Constr. Co. v. S & H Contractors, Inc.*, 443 S.W.2d 227 (Ky. Ct. App. 1969); *Moore v. Moore*, 272 So.2d 407, 410 (La. Ct. App. 1973); *Iwanosky v. Iwany*, 319 A.2d 339 (Me. 1974) ("clear, strong, satisfactorily & constituted"); *Peurifoy v. Congressional Motors, Inc.*, 254 Md. 501, 255 A.2d 332 (1969); *Transitron Elec. Corp. v. Hughes Aircraft Co.*, 649 F.2d 871 (1st Cir. 1981) (applying Mass. law); *Hi-Way Motor Co. v. International Harvester, Co.*, 398 Mich. 330, 247 N.W.2d 813 (1976); *Weise v. Red Owl Stores, Inc.*, 286 Minn. 199, 175 N.W.2d 184 (1970); *Barrett v. Turner*, 229 So.2d 563 (Miss. 1969); *Page v. Andreasen*, 200 Neb. 641, 264 N.W.2d 682 (1978); *Lubbe v. Barbee*, 91 Nev. 596, 540 P.2d 115 (1975); *Hoyt v. Horst*, 105 N.H. 380, 201 A.2d 118 (1964); *Caledonia, Inc. v. Trainor*, 123 N.H. 116, 459 A.2d 613 (1983); *Blowit v. Dolitsky*, 124 N.J. Super. 101, 304 A.2d 774 (1973); *Rael v. Cisneros*, 82 N.M. 705, 487 P.2d 133 (1971); *Simcusi v. Saeli*, 44 N.Y.2d 442, 377 N.E. 713, 406 N.Y.S.2d 259 (1978); *Bahner v. Hoeven*, 228 N.W.2d 893 (N.D. 1975) ("clear & satisfactory"); *Daubert v. Mosley*, 487 P.2d 353 (Okla. 1971) ("clear & satisfactory"); *Bausch v. Myers*, 273 Or. 376, 541 P.2d 817 (1975); *Yoo Hoo Bottling Co. v. Leibowitz*, 432 Pa. 117, 247 A.2d 469 (1968); *Frankfurt v. Wilson*, 353 S.W.2d 490 (Tex. Civ. App. 1961) ("clear & satisfactory"); *Schwartz v. Tanner*, 576 P.2d 873 (Utah 1978); *Bardill Land & Lumber, Inc. v. Davis*, 135 Vt. 81, 370 A.2d 212 (1977) ("clear & satisfactory"); *Gibson v. Gibson*, 207 Va. 821, 153 S.E.2d 189 (1967); *Beckett v. Department of Social & Health Servs.*, 87 Wash.2d 184, 550 P.2d 529 (1976); *General Elec. Credit Corp. v. Fields*, 140 W.Va. 176, 133 S.E.2d 780 (1964) ("clear & distinct"); *Miles v. Mackle Bros.*, 73 Wis.2d 84, 242 N.W.2d 247 (1976); *Schaffer v. Standard Timber Co.*, 79 Wyo. 137, 331 P.2d 611 (1958); *Gilbert v. Mid-South Mach. Co.*, 267 S.C. 211, 227 S.E.2d 189 (1976); *Fox v. Wilson*, 211 Kan. 563, 507 P.2d 252 (1973) ("quality" of the evidence judged by clear and convincing, "quantity" judged by preponderance).

is true today.<sup>7</sup> A distinct minority of states appear to follow the preponderance standard exclusively.<sup>8</sup> Several states employ a

<sup>7</sup> *D.H. Dep't Store v. Feil*, 472 So.2d 1001 (Ala. 1985); *Rhoads v. Harvey Publications, Inc.*, 145 Ariz. 142, 700 P.2d 840 (1984); *Ficor, Inc. v. McHugh*, 639 P.2d 385 (Colo. 1982); *Miller v. Appleby*, 183 Conn. 51, 438 A.2d 811, 813 (1981) ("clear & satisfactory"); *Dobison v. Bank of Hawaii*, 60 Haw. 225, 587 P.2d 1234 (1978); *Magic Valley Potato Shippers v. Continental Ins.*, 112 Idaho 1073, 739 P.2d 372 (1987); *Hoffman v. Hoffman*, 94 Ill.2d 205, 446 N.E.2d 499 (1983); *Hall v. Wright*, 261 Iowa 758, 156 N.W.2d 661 (1968) (preponderance that is clear, satisfactory and convincing); *Fox v. Wilson*, 211 Kan. 563, 507 P.2d 252 (1973) ("quality" of the evidence judged by clear and convincing, "quantity" judged by preponderance); *Sanford Constr. Co. v. S & H Contractors, Inc.*, 443 S.W.2d 227 (Ky. Ct. App. 1969); *Butler v. Poulin*, 500 A.2d 257 (Me. 1985); *Peurifoy v. Congressional Motors, Inc.*, 254 Md. 501, 255 A.2d 332 (1969); *Transitron Elec. Corp. v. Hughes Aircraft Co.*, 649 F.2d 871 (1st Cir. 1981) (Mass. law); *Hi-Way Motor Co. v. International Harvester, Co.*, 398 Mich. 330, 247 N.W.2d 813 (1976); *Weise v. Red Owl Stores, Inc.*, 286 Minn. 199, 175 N.W.2d 184 (1970); *Barrett v. Turner*, 229 So.2d 563 (Miss. 1969); *Tobin v. Flynn & Larsen Implement Co.*, 220 Neb. 259, 369 N.W.2d 96 (1985) (clear and convincing in equity cases, preponderance at law); *Lubbe v. Barbee*, 91 Nev. 596, 540 P.2d 115 (1975); *Caledonia, Inc. v. Trainor*, 123 N.H. 116, 459 A.2d 613 (1983); *Stochastic Decisions, Inc. v. DiDomenico*, 236 N.J. Super. 388, 565 A.2d 1133 (N.J. Super. Ct. App. Div. 1989); *Simcusi v. Saeli*, 44 N.Y.2d 442, 377 N.E. 713, 406 N.Y.S.2d 259 (1978); *Norwest Bank Bismark v. Faiman*, 420 N.W.2d 357 (N.D. 1988) ("clear & satisfactory"); *Bausch v. Myers*, 273 Or. 376, 541 P.2d 817 (1975); *Yoo Hoo Bottling Co. v. Leibowitz*, 432 Pa. 117, 247 A.2d 469 (1968) ("clear & convincing"); *Rutledge v. St. Paul Fire & Marine Ins. Co.*, 286 S.C. 360, 334 S.E.2d 131 (1985); *Frankfurt v. Wilson*, 353 S.W.2d 490 (Tex. Civ. App. 1961) ("clear & satisfactory preponderance"); *Schwartz v. Tanner*, 576 P.2d 873 (Utah 1978); *Bardill Land & Lumber, Inc. v. Davis*, 135 Vt. 81, 370 A.2d 212 (1977) ("clear & satisfactory"); *Beckett v. Department of Social & Health Servs.*, 87 Wash.2d 184, 550 P.2d 529 (1976); *Tri-State Asphalt Prods. v. McDonough Co.*, 391 S.E.2d 907 (W.Va. 1990); *Miles v. Mackle Bros.*, 73 Wis.2d 84, 242 N.W.2d 247 (1976); *Duffy v. Brown*, 708 P.2d 433 (Wyo. 1985).

<sup>8</sup> *Saxon v. Harris*, 395 P.2d 71 (Alaska 1964); *Killion v. Hayes Bros. Lumber Co.*, 251 Ark. 121, 470 S.W.2d 939 (1971); *Liodas v. Sahad*, 137 Cal. Rptr. 635, 562 P.2d 316 (1977); *Kern v. NCD Indus., Inc.*, 316 A.2d 576 (Del. Ch. 1973); *Watson Realty Corp. v. Quinn*, 452 So.2d 568 (Fla. 1984); *O'Connell v. Supreme Conclave Knights*, 102 Ga. 143, 28 S.E. 282 (1897); *Baltimore, O. & C. R. Co. v. Scholes*, 14 Ind. App. 524, 43 N.E. 156 (1896); *Cowan v. Westland Realty Co.*, 162 Mont. 379, 512 P.2d 714 (1973); *Ostalkiewicz v. Guardian Alarm*, 520 A.2d 563 (R.I. 1987); *Jennings v. Jennings*, 309 N.W.2d 809 (S.D. 1981); *Calhoun v. Baylor*, 646 F.2d 1158 (6th Cir. 1981) (applying Tennessee law).

semantic hybrid of the two,<sup>9</sup> and some states apparently use both.<sup>10</sup> In several other states the standard depends upon the facts or circumstances of the particular fraud case.<sup>11</sup> One state genuinely has mixed the two standards.<sup>12</sup>

States advocating the clear and convincing standard offer various reasons for the higher standard: (1) to overcome the strong presumption against fraud or bad faith,<sup>13</sup> (2) to set aside written instruments because they have a higher presumption of

<sup>9</sup> See, e.g., *Hall v. Wright*, 261 Iowa 758, 156 N.W.2d 661 (1968) ("preponderance of the evidence that is clear and convincing").

<sup>10</sup> The Missouri Supreme Court has held that the standard of proof in fraudulent misrepresentation cases "should not be greater than in other cases tried to juries." *Crawford v. Smith*, 470 S.W.2d 529, 533 (Mo. 1971). *Crawford*, however, has been distinguished as applying only to cases at law. *In re Estate of Mitchell*, 610 S.W.2d 681 (Mo. App. 1980). Other Missouri courts have held that fraud must be proven by clear and convincing evidence. *South Side Nat'l Bank v. Winfield Fin. Servs. Corp.*, 783 S.W.2d 140 (Mo. App. 1989); *Center Bank v. Bliss*, 765 S.W.2d 276 (Mo. App. 1988); *Barrett v. Flynn*, 728 S.W.2d 288 (Mo. App. 1987).

<sup>11</sup> Ohio uses the preponderance standard in traditional civil fraud cases but applies the clear and convincing standard if the complaining party seeks to set aside a written instrument. *Household Fin. Corp. v. Altenberg*, 5 Oh. St. 2d 190, 214 N.E.2d 667 (1966). Nebraska holds that the preponderance standard applies to cases at law while the clear and convincing standard applies to cases in equity. *Tobin v. Flynn & Larsen Implement Co.*, 220 Neb. 259, 269 N.W.2d 96 (1985). North Carolina uses the preponderance standard in actions to set aside written instruments, but requires the clear and convincing standard in actions to reform a document. *Maynard v. Durham & S. Ry. Co.*, 112 S.E.2d 249 (N.C. 1960), *rev'd on other grounds*, 365 U.S. 160 (1961).

<sup>12</sup> In Kansas, courts apply the two standards to different elements of the evidence. The "preponderance" standard applies to the "quantum" or quantity of the evidence while the "clear and convincing" standard applies to the "character" or quality of the evidence. *Fox v. Wilson*, 211 Kan. 563, 507 P.2d 252, 265 (1973).

<sup>13</sup> See, e.g., *Barrett v. Turner*, 229 So.2d 563 (Miss. 1969) (proof must not only preponderate over the defendant's evidence but must overcome the strong presumption of innocence); *Sajich v. Sajich*, 129 Ill.App.2d 432, 262 N.E.2d 11, 14 (1970) (because of the presumption that all persons are innocent, the higher burden of proof is needed).

validity than oral evidence,<sup>14</sup> and (3) to guard against the potential damage to a party's reputation by fraud claims, which by their nature can be fabricated easily.<sup>15</sup>

On various occasions, this Court has held that fraud must be proved by clear and convincing evidence. See, e.g., *Addington v. Texas*, 441 U.S. 418, 424 (1979); *Lalone v. United States*, 164 U.S. 255 (1896); *United States v. American Bell Tel. Co.*, 167 U.S. 224 (1897) (citing *Colorado Coal & Iron Co. v. United States*, 123 U.S. 307 (1887)). In *Lalone*, the Court observed that "the rule is of long standing and is of universal application, that the evidence tending to prove . . . fraud . . . must be clear and satisfactory." *Lalone*, 164 U.S. at 257.

In requiring the higher standard in this case for section 523(a)(2) proceedings, the Eighth Circuit stated that it was following the majority rule. *In re Garner*, 881 F.2d 579, 581 (8th Cir. 1989). In doing so, the court properly presumed that Congress was aware that the prevailing view at the time of enactment of the Code was that fraud, for both section 523 and state common law purposes, had to be proved by clear and convincing evidence. *Id.* at 582. The court was following its earlier decision in *In re Van Horne*, 823 F.2d 1285 (8th Cir. 1987), namely that "[c]reditors bear the burden of proof . . . and must prove each element of their claim by clear and convincing evidence." *Id.* at 1287.

What the Eighth Circuit described as the majority rule is in fact the universal rule of the United States Courts of Appeals that have addressed the issue. There is no split among the circuits in the context of section 523(a)(2) proceedings. *Allstate Ins. Co. v. Foreman*, No. 89-4516, slip op. at 4 (5th Cir., July 2, 1990) (1990 W.L. 89467) ("Cognizant of the overarching policy in the Bankruptcy Code in favor of giving the debtor an

<sup>14</sup> See *supra* notes 4 and 5. See also *Maxwell Land-Grant Case*, 121 U.S. 325, 381 (1887).

<sup>15</sup> See, e.g., *Disner v. Westinghouse Elec. Corp.*, 726 F.2d 1106, 1110 (6th Cir. 1984) ("Courts have recognized, perhaps because the nature of the evidence in cases involving allegations of fraud is often circumstantial, that claims of fraud can be fabricated easily.").

opportunity for a fresh start, we endorse the application of the "clear and convincing" standard in the § 523(a)(2) dischargeability context"); *In re Gerlach*, 897 F.2d 1048, 1052 (10th Cir. 1990) ("A creditor seeking to have a debt declared non-dischargeable . . . must prove that it comes within the statute by clear and convincing evidence"); *In re Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986) ("The burden is on the creditor to prove the debtor's culpability [under section 523(a)(2)] by clear and convincing evidence"); cf. *Chrysler Credit Corp. v. Rebhan*, 842 F.2d 1257, 1262 (11th Cir. 1988) ("There is no question but that the parties seeking to except a debt from discharge must prove the willfulness and maliciousness of the act [under section 523(a)(6)] by clear and convincing evidence"); *In re Phillips*, 804 F.2d 930, 932 (6th Cir. 1986) ("A creditor seeking an exception from discharge under Section 523(a)(2) must sustain this burden by clear and convincing evidence"); *In re Black*, 787 F.2d 503, 505 (10th Cir. 1986) ("A creditor seeking to have a debt declared nondischargeable under [section 523(a)(2)(A)] must prove that it comes within the statute by clear and convincing evidence"); *In re Martin*, 761 F.2d 1163, 1165 (6th Cir. 1985) ("The party seeking an exception from discharge under section 523(a)(2) has the burden of proof by clear and convincing evidence"); *In re Kimzey*, 761 F.2d 421, 423-24 (7th Cir. 1985) ("The party objecting to discharge must prove the facts establishing each element [under section 523(a)(2)] by clear and convincing evidence"). See also *In re Braen*, 900 F.2d 621, 624-25 (3d Cir. 1990) (dicta declaring that clear and convincing evidence is universally required of creditors claiming fraud); *In re Dougherty*, 84 B.R. 653, 656 (Bankr. 9th Cir. 1988) (creditors must prove each of the elements of a dischargeability action by clear and convincing evidence); 3 L. King, R. Babitt, A. Herzog & R. Levin, *Collier on Bankruptcy*, § 523.08[5] (15th ed. 1990) ("At the time of the Code's enactment in 1978, courts were holding that for purposes of bringing a debt within Section 17a(2) of the Bankruptcy Act of 1898, the fraud had to be proved by clear and convincing evidence") (footnotes and citations omitted).

Petitioners cite *Combs v. Richardson*, 838 F.2d 112 (4th Cir. 1988), to suggest there is a split among the circuits regarding the burden of proof in section 523(a)(2) cases. However, the issue in *Combs* was whether a debt was nondischargeable in bankruptcy under section 523(a)(6), which deals with willful and malicious injury (assault), not under section 523(a)(2), which deals with fraud. The Fourth Circuit concluded that in light of the Code's silence regarding the standard of proof the courts "may not imply a higher standard than the preponderance standard normally applied in civil proceedings." *Id.* at 116. This holding is contrary to *Chrysler Credit Corp. v. Rebhan*, 842 F.2d 1257, 1262 (11th Cir. 1988), which required proof by clear and convincing evidence under section 523(a)(6). While there is, then, a split among the circuits with respect to the burden of proof under section 523(a)(6), the circuit courts uniformly have required clear and convincing evidence to prove fraud under section 523(a)(2). *Combs* is distinguishable from the instant case because it dealt with a non-fraud question. Accord *In Re Pappas*, 107 B.R. 95, 99 n.3 (Bankr. W.D. Va. 1989) (citing *Oriel v. Russell*, 278 U.S. 358 (1929)). In *Oriel*, the Court held that a motion for a bankruptcy turnover order must be established by clear and convincing evidence. "It is a charge equivalent to one of fraud, and must be established by the same kind of evidence required in a case of fraud in a court of equity. A mere preponderance of evidence in such a case is not enough." *Oriel*, 278 U.S. at 362.

The Third Circuit recently followed *Combs* regarding the burden of proof in section 523(a)(6) cases, but specifically distinguished those "willful and malicious" cases from section 523(a)(2) "fraud" cases. *In re Braen*, 900 F.2d 621 (3d Cir. 1990). Although refusing to apply the clear and convincing standard to section 523(a)(6), the *Braen* court distinguished its decision from many others involving section 523(a)(2), including *In re Garner*, 881 F.2d 579. The Third Circuit stated that section 523(a)(2) cases involve claims of fraud, and "common law actions for fraud have historically employed the heavier clear and convincing evidence burden of proof." *In re Braen*,

900 F.2d at 625 & n.2 (citing *Lalone v. United States*, 164 U.S. 255, 257 (1896)). Moreover, the court noted that the clear and convincing standard is "universally required of creditors claiming fraud," and that "virtually all courts have adopted the clear and convincing standard in disputes under § 523(a)(2) . . . ." 900 F.2d at 625.

In universally requiring clear and convincing evidence in section 523(a)(2) cases, the courts of appeals have relied on several grounds, including (1) the necessity to overcome the presumption of innocence, *In re Black*, 787 F.2d at 505; *In re Hunter*, 780 F.2d at 1579; (2) the authority of the leading bankruptcy treatises, *In re Phillips*, 804 F.2d at 932; *In re Black*, 787 F.2d at 505; (3) the fresh start policy, *In re Van Horne*, 823 F.2d at 1287; *In re Garner*, 881 F.2d at 582; *Allstate Ins. Co.*, slip op. at 4 (1990 W.L. 89467); and (4) that exceptions to discharge under section 523(a) are to be strictly construed against the objecting creditor, *Allstate Ins. Co.*, slip op. at 4 (1990 W.L. 89467); *In re Van Horne*, 823 F.2d at 1287; *In re Gerlach*, 897 F.2d at 1052; *In re Black*, 787 F.2d at 505; and *In re Dougherty*, 84 B.R. at 656.

The overwhelming majority of the bankruptcy courts to address the issue have applied the clear and convincing standard in section 523(a)(2) fraud cases, many declaring that the higher standard applies in all cases under section 523(a).<sup>16</sup> Few juris-

<sup>16</sup> *In re Cheatham*, 44 B.R. 4 (Bankr. N.D. Ala. 1984) (§ 523(a)(2)); *In re Hefner*, 69 B.R. 257 (Bankr. N.D. Ala. 1986) (all § 523(a) actions); *In re Morgan*, 106 B.R. 573 (Bankr. E.D. Ark. 1989) (§ 523(a)(4) case, but states that all § 523(a) is clear and convincing); *In re Kissinger*, 106 B.R. 180 (Bankr. E.D. Ark. 1989) (§ 523(a)(2)(A)); *In re Drayman*, 77 B.R. 773 (Bankr. C.D. Cal. 1987) (§ 523(a)(2)); *In re Tilbury*, 74 B.R. 73 (Bankr. 9th Cir. 1987), *aff'd*, 851 F.2d 361 (9th Cir. 1988) (§ 523(a) generally when relating to fraud); *In re Buck*, 75 B.R. 417 (Bankr. N.D. Cal. 1987); *In re McClure*, 70 B.R. 955 (Bankr. S.D. Cal. 1987) (§ 523(a)(2)(A)); *In re Perea*, 89 B.R. 128 (Bankr. D. Colo. 1988) (§ 523(a) cases generally); *In re Mills*, 73 B.R. 168 (Bankr. D. Colo. 1986); *In re*

dictions unequivocally have applied the preponderance

*Perez*, 94 B.R. 765 (Bankr. M.D. Fla. 1988) (§ 523 generally); *In re Klag*, 112 B.R. 456 (Bankr. M.D. Fla. 1990) (§ 523(a)(2)(A)); *In re Stivers*, 84 B.R. 852 (Bankr. S.D. Fla. 1988) (§ 523(a)(2)(A)); *In re Picou*, 81 B.R. 152 (Bankr. S.D. Fla. 1988) (§ 523 generally); *In re Ayers*, 83 B.R. 83 (Bankr. M.D. Ga. 1988) (all § 523 actions); *In re Fontana*, 92 B.R. 559 (Bankr. M.D. Ga. 1988) (§ 523(a) generally); *In re Thomas*, 54 B.R. 287 (Bankr. D. Haw. 1985) (§ 523(a)(2)(A)); *In re Bonnet*, 73 B.R. 715 (C.D. Ill. 1987), *rev'd on other grounds*, 895 F.2d 1155 (7th Cir. 1989) (§ 523(a) generally); *In re Pochel*, 64 B.R. 82 (Bankr. C.D. Ill. 1986) (§ 523(a)(2)(A)); *In re Williams*, 85 B.R. 434 (Bankr. N.D. Ill. 1988) (§ 523(a)(2)); *In re Reitz*, 69 B.R. 192 (Bankr. N.D. Ill. 1986) (prior state court judgment on fraud); *In re Fitzgerald*, 109 B.R. 893 (Bankr. N.D. Ind. 1989) (§ 523(a)(2)(A)); *In re Gallagher*, 72 B.R. 830 (Bankr. N.D. Ind. 1987) (§ 523(a) generally); *In re Howard*, 73 B.R. 694 (Bankr. N.D. Ind. 1987) (§ 523(a)(2)); *In re Bonafas*, 41 B.R. 74 (Bankr. N.D. Iowa 1984) (§ 523(a)(2)(A)); *In re Smith*, 54 B.R. 299 (Bankr. S.D. Iowa 1985) (§ 523(a)(2)(C), but standard applies to § 523(a) generally); *In re Sayler*, 68 B.R. 111 (Bankr. D. Kan. 1986), *rev'd and remanded on other grounds*, 98 B.R. 536 (D. Kan. 1987) (§ 523(a)(2)(A)); *In re Roeder*, 61 B.R. 179 (Bankr. W.D. Ky. 1986) (§ 523(a)(2)); *In re Aldrich*, 16 B.R. 825 (Bankr. W.D. Ky. 1982); *but see In re Carr*, 49 B.R. 208 (Bankr. W.D. Ky. 1985); *In re Lamb*, 28 B.R. 462 (Bankr. W.D. La. 1983) (§ 523(a)(2)(A)); *In re Lyon*, 8 B.R. 152 (Bankr. D. Mo. 1981) (§ 523(a)(2)); *In re King*, 96 B.R. 413 (Bankr. D. Mass. 1989) (§ 523(a)(2)(B)); *In re Conley*, 78 B.R. 3 (Bankr. D. Mass. 1987) (§ 523(a)(2)(A)); *In re D'Annolfo*, 54 B.R. 887 (Bankr. D. Mass. 1985) (§ 523(a)(2)); *but see In re Daboul*, 85 B.R. 197 (Bankr. D. Mass. 1988) (preponderance with prior jury verdict on fraud under § 523(a)(2)); *In re Wellever*, 103 B.R. 856 (Bankr. W.D. Mich. 1989) (§ 523(a)(2), but preponderance for all else); *In re Hames*, 53 B.R. 868 (Bankr. D. Minn. 1985) (§ 523(a)(2)(A)); *In re Eberle*, 61 B.R. 638 (Bankr. D. Minn. 1985) (all § 523(a) actions); *Schwartz v. Renville Farmers Co-op Credit Union*, 44 B.R. 266 (Bankr. D. Minn. 1984) (§ 523(a)(2)(A)); *In re Self*, 51 B.R. 686 (Bankr. D. Miss. 1985) (§ 523(a)(2)); *In re Pyles*, 38 B.R. 92 (Bankr. W.D. Mo. 1984) (§ 523(a)(2)); *In re Canon*, 43 B.R. 733 (Bankr. W.D. Mo. 1984) (state court default judgment on fraud); *In re Sullivan*, 111 B.R. 317 (Bankr. D. Mont. 1990) (§ 523(a)(2)); *In re Riso*, 74 B.R. 750 (Bankr. D.N.H. 1987) (§ 727 case, but applies § 523(a) standard); *In re McIntyre*, 64 B.R. 27 (D.N.H. 1986) (§ 523(a)(2)); *In re Cook*, 21 B.R. 112 (Bankr. D.N.M. 1982) (§ 523(a)(2)(B), prior state court judgment); *In re Billings*, 94 B.R. 803 (Bankr. E.D.N.Y. 1989) (§ 523(a)(2)(A), prior default judgment in non-bankruptcy action on fraud); *In re Newmark*, 20 B.R. 842 (Bankr. E.D.N.Y. 1982) (§ 523 generally); *but see In re Baita*, 12 B.R. 813 (Bankr. E.D.N.Y. 1981) (§ 523(a)(2)(B), preponderance standard); *In re Verdon*, 95 B.R. 877 (Bankr. N.D.N.Y. 1989) (§ 523(a)(2)(A)); *In re Bossard*, 74 B.R. 730 (Bankr. N.D.N.Y. 1987) (all § 523 actions); *In re Schwartz*, 45 B.R. 354 (Bankr. S.D.N.Y.

standard.<sup>17</sup>

Petitioners and amici decry the inconsistency they claim will result if different burdens of proof are applied to different

1985) (§ 523(a)(2)(A)); *In re Gans*, 75 B.R. 474 (Bankr. S.D.N.Y. 1987) (§ 523(a)(2)(A)); *In re Jenkins*, 61 B.R. 30 (Bankr. D.N.D. 1986) (§ 523(a)(2)); *In re Burke*, 83 B.R. 716 (Bankr. D.N.D. 1988) (§ 523 generally); *In re Lang*, 108 B.R. 586 (Bankr. N.D. Ohio 1989) (§ 523(a)(2)(A)); *In re Constantino*, 72 B.R. 231 (Bankr. N.D. Ohio 1987) (§ 523(a)(2)); *In re Ritzer*, 105 B.R. 424 (Bankr. S.D. Ohio 1989) (§ 523(a)(2)(A)); *In re Browning*, 31 B.R. 995 (Bankr. S.D. Ohio 1983) (§ 523(a)(2)(A)); *In re Eversole*, 110 B.R. 318 (Bankr. S.D. Ohio 1990) (§ 523(a)(2)); *In re Lowther*, 32 B.R. 638 (Bankr. W.D. Okla. 1983) (§ 523(a)(2)(A)); *In re Farley*, 15 B.R. 11 (Bankr. D. Or. 1981) (§ 523(a)(2)(A), prior state court jury verdict against debtor on fraud); *United States v. Stelweck*, 108 B.R. 488 (Bankr. E.D. Pa. 1989) (§ 523(a)(2), follows majority); *In re Garcia*, 88 B.R. 695 (Bankr. E.D. Pa. 1988) (clear and convincing for § 523(a)(2) and preponderance for all others); *In re James*, 94 B.R. 350 (Bankr. E.D. Pa. 1988) (clear and convincing for § 523(a)(2)(A)); *In re O'Karma*, 46 B.R. 422 (M.D. Pa. 1984) (§ 523(a)(2)(B)); *In re Ward*, 88 B.R. 727 (Bankr. W.D. Pa. 1988) (§ 523(a)(2)); *In re Liptak*, 89 B.R. 3 (Bankr. W.D. Pa. 1988) (§ 523(a)(2)(B)); *In re Walker*, 7 B.R. 216 (Bankr. D.R.I. 1980) (§ 35(a)(2), predecessor of § 523(a)(2)); *In re Marks*, 40 B.R. 614 (Bankr. D.S.C. 1984) (§ 523(a)(2)(A)); *In re Adelman*, 90 B.R. 1012 (Bankr. D.S.D. 1988) (§ 523(a)(2)(A)); *In re White*, 106 B.R. 501 (Bankr. E.D. Tenn. 1989) (§ 523(a)(2)(A)); *In re Ashley*, 5 B.R. 262 (Bankr. E.D. Tenn. 1980) (§ 523(a)(2)); *In re Church*, 69 B.R. 425 (Bankr. N.D. Tex. 1987) (all § 523(a) actions); *In re Iverson*, 66 B.R. 219 (Bankr. D. Utah 1986) (§ 523(a)(2)(B)); *In re Huff*, 1 B.R. 354 (Bankr. D. Utah 1979) (§ 17(a)(2), predecessor to § 523(a)(2)); *In re Zack*, 99 B.R. 717 (Bankr. E.D. Va. 1989) (clear and convincing for § 523(a) and preponderance for all else); *In re Knott*, 32 B.R. 252 (Bankr. E.D. Va. 1983) (§ 523(a) generally); but see *In re Basham*, 106 B.R. 453 (Bankr. E.D. Va. 1989); *In re Barrup*, 37 B.R. 697 (Bankr. D. Vt. 1983), *reh'g denied*, 53 B.R. 215 (Bankr. D. Vt. 1985) (§ 523 generally); *In re Kaufmann*, 57 B.R. 644 (Bankr. E.D. Wis. 1986) (§ 523(a)(2)(A)); *In re Brink*, 30 B.R. 28 (Bankr. W.D. Wis. 1983) (§ 523(a)(2), false representation); *In re Trewyn*, 12 B.R. 543 (Bankr. W.D. Wis. 1981) (§ 523(a)(2)).

<sup>17</sup> *In re Ayala*, 107 B.R. 271 (Bankr. E.D. Cal. 1989) (§ 727 case, but would apply to § 523); *In re Stowell*, 102 B.R. 589 (Bankr. W.D. Tex. 1989), *modified in part, vacated in part*, 113 B.R. 322 (Bankr. W.D. Tex. 1990); *In re Showalter*, 86 B.R. 877 (Bankr. W.D. Va. 1988).

types of nondischargeable debts under section 523.<sup>18</sup> In fact, these differences always have existed and certainly prevailed at the time of the adoption of the Code. Moreover, nothing in the legislative history or any other legal authority suggests that the same burden or proof must apply to all claims under section 523(a).<sup>19</sup> In fact, the Third Circuit has held that:

[B]ecause Section 523 covers so many disparate circumstances, we doubt that Congress, without so stipulating, expected bankruptcy courts to apply a single standard of proof in all instances where a creditor asks for a declaration of nondischargeability. The suggestion, for example, that Congress intended the courts to require of spouses alleging a failure to pay child support the same kind of clear and convincing evidence universally required of creditors claiming fraud strikes us as farfetched.

*In re Braen*, 900 F.2d at 625.

<sup>18</sup> Under section 523 the following types of debts are nondischargeable: (1) taxes or custom duties; (2) money or property obtained by false pretenses, a false representation or actual fraud; (3) claims that were not timely filed; (4) fraud while acting in a fiduciary capacity, embezzlement or larceny; (5) alimony, maintenance or child support payments; (6) willful and malicious injury to the debtor; (7) fines, penalties or forfeitures to governmental units; (8) educational loans; and (9) judgments or consent decrees against a debtor resulting from the operation of a motor vehicle while legally intoxicated. 11 U.S.C. 523(a) (1988).

<sup>19</sup> To the contrary, at the time of the 1970 amendments to the Bankruptcy Code, Congress explicitly recognized that different types of activities had been grouped together as grounds to except a debt from discharge. The Explanatory Memorandum to accompany the Bill amending § 17 of the Bankruptcy Act states:

Section 14 of the Bankruptcy Act sets forth the statutory and only grounds upon which a discharge may be denied. With the exception of the grounds specified in clauses (5) and (8), all such grounds have their foundation in some form and degree of dishonesty or lack of cooperation on the part of the bankrupt. On the other hand, the grounds listed in clauses (5) and (8) are entirely distinct from such type of activity and, in fact, are such that some conflict of application and interpretation has arisen among the Courts.

Act of October 19, 1970, Pub. L. No. 91-467, 1970 U.S. Code Cong. & Admin. News (84 Stat. 990) 1156, 4161 (Explanatory Memorandum to Accompany Bill).

As noted by amici, some federal statutes which authorize suit by the United States specify that the government may prove its case by a mere preponderance of the evidence. However, those statutes, like the securities laws, are not "coextensive with common-law doctrines of fraud." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983). The *Huddleston* Court found that Congress intended the securities industry to conform to a higher standard of conduct. Therefore, a lesser standard of proof was consistent with "an important purpose of the federal securities statutes . . . to rectify perceived deficiencies in the available common-law protections . . . ." *Id.* at 389. Accordingly, the Court rejected application of the common law requirement of clear and convincing evidence in actions under section 10(b) of the 1934 Securities Exchange Act. *Id.* at 388.

One of the statutes cited by amici, the False Claims Act, 31 U.S.C. §§ 3729-3731 (1982), was amended in 1986 to provide that actions thereunder be proved by a preponderance of the evidence. False Claims Amendment Act of 1986, Pub. L. 99-562, 100 Stat. 3158 (codified at 31 U.S.C. § 3731(c)). Certainly, Congress in 1986 must be deemed to have known the general rule that proof of fraud is by clear and convincing evidence. In fact, the legislative history reveals that Congress analogized this statute to the securities laws and favorably relied on this Court's decision in *Huddleston* in enacting 31 U.S.C. § 3731(c). S. Rep. No. 99-345, 99th Cong., 2d Sess. 31, reprinted in 1986 U.S. Code Cong. & Admin. News 5266, 5296. The same can be said of the enactment in August 1989 of 12 U.S.C. § 1833a(e) of the Federal Deposit Insurance Act, 12 U.S.C. §§ 1811-1833e (1950), providing for recovery by the Attorney General by a preponderance of the evidence. Like the securities laws, these various statutes are not coextensive with common law doctrines of fraud. These laws presumably were enacted to rectify perceived deficiencies in the available common-law protections and to establish higher standards of conduct for certain activities.

Amici also bemoan the unfair burden on the government if fraud must be proved by clear and convincing evidence in section 523(a)(2) proceedings. If such a burden exists, it can be alleviated simply by Congressional amendment to the Bankruptcy Code specifying the preponderance standard, as Congress has done in other federal statutes.

By affirming the judgment of the Eighth Circuit in this case, the Court simply will endorse the practice of every Court of Appeals and virtually every bankruptcy court that has addressed the issue. A decision in Respondent's favor will not open the floodgates to "relitigation," and it will not transform the bankruptcy courts into a shelter for wrongdoers. If there were any legitimate basis for that fear, the catastrophic results forecast by amici would have appeared long ago.

#### B. The "Fresh Start" Doctrine Compels Application of the Clear and Convincing Evidence Standard in Section 523(a)(2) Proceedings

The clear and convincing standard is consistent with the fresh start policy of the Bankruptcy Code. The bankruptcy discharge "represents an independent . . . public policy in favor of extricating an insolvent debtor from what would otherwise be a financial impasse." *United States v. Kras*, 409 U.S. 434, 447 (1973) (quoting J. MacLachlan, *Bankruptcy* 88 (1956)). The centerpiece of the 1898 Bankruptcy Act was the ability to obtain a discharge of one's debts. National Bankruptcy Act, ch. 541, § 2, 30 Stat. 545 (1898) (current version at 11 U.S.C. § 523 (1988)). The bankruptcy discharge—the means by which the "fresh start" doctrine is effectuated—is of sufficient importance that Congress has provided procedural safeguards against waiving the discharge. 11 U.S.C. § 524(c),(d) (1988).

The primary purpose of the 1898 Act was noted by the Court as early as 1915 in *Williams v. United States Fidelity & Guaranty Co.*, 236 U.S. 549 (1915): (1) to secure an equitable distribution of the debtor's assets among his creditors in partial payment of his debts; and (2) to release the debtor from the

burden of his obligations so that he may be given a new economic start in life. *Id.* at 554-55.

This Court later declared that: "One of the primary purposes of the bankruptcy act is to 'relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.'" *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams*, 236 U.S. at 554-55). The fresh start provides the bankrupt with "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Id.*

The 1898 Act mandated a discharge unless the debtor was found to have committed one or more wrongful acts enumerated in section 14c rendering the bankrupt unworthy of being released from his or her obligations. The Act also provided for the exception of certain individual debts from discharge, including liabilities for obtaining money or property by false pretenses or false representations. 3 Liking, R. Babitt, A. Herzog & R. Levin, *Collier on Bankruptcy* ¶ 523.01 (15th ed. 1990). The Court has mandated that exceptions to discharge be strictly construed. *Gleason v. Thaw*, 236 U.S. 558, 562 (1915); see also 3 L. King, R. Babbitt, A. Herzog & R. Levin, *Collier on Bankruptcy* ¶ 523.05 n.3 (15th ed. 1990) ("Since the exceptions to dischargeability substantially frustrate the fresh start objective of the Code and the rehabilitative goal of the discharge provisions, they are to be strictly construed against an objecting creditor and in favor of the debtor's right to discharge of debts") (citations omitted).

In 1970, Congress amended the Bankruptcy Act to grant bankruptcy courts exclusive jurisdiction to resolve questions of dischargeability. *Brown v. Felsen*, 442 U.S. 127, 135-36 (1979). Sections 2a(12) and 38(4) were amended to give bankruptcy courts and referees additional jurisdiction to determine dischargeability of debts. Act of October 19, 1970, Pub. L. No. 91-467, 1970 U.S. Code Cong. & Admin. News (84 Stat. 990) 1156, 4161 (Explanatory Memorandum To Accompany Bill). The major purpose of the 1970 Amendments was "to effectuate,

more fully, the discharge in bankruptcy by rendering it less subject to abuse by harassing creditors." H.R. Rep. No. 1502, 91st Cong., 2d Sess. 1, reprinted in 1970 U.S. Code Cong. & Admin. News 4156, 4156. This concept of "exclusive jurisdiction" is carried forward in the 1978 Act in 11 U.S.C. § 523(c) and implements the Constitutional mandate that Congress establish "uniform laws on the subject of Bankruptcy throughout the United States." U.S. Const., art. I, § 8, cl. 4. See *In re Rudd*, 104 B.R. 8, 13 (Bankr. N.D. Ind. 1987).

The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978), was enacted to modernize and improve the efficiency and fairness of the bankruptcy process. See generally H. R. Rep. No. 595, 95th Cong., 1st Sess. 1, reprinted in 1978 U.S. Code Cong. & Admin. News 5963; S. Rep. No. 989, 95th Cong., 2d Sess. 1, reprinted in 1978 U.S. Code Cong. & Admin. News 5787. The 1978 Act also intended to carry forward the "fresh start" policy. S. Rep. No. 989 at 6. The basic discharge provisions were not changed.

The 1978 Act reflects Congress' continuing commitment to protect the discharge and promote the debtor's opportunity for a fresh start in life. Congress included section 523(d) specifically to protect debtors and to preserve the integrity of the fresh start doctrine. This new section permits the debtor to recover costs and attorneys fees if the court finds that a creditor, lacking good faith, challenges dischargeability in the hope of extracting a settlement with the debtor. "Such practices impair the debtor's fresh start and are contrary to the spirit of the bankruptcy laws." S. Rep. No. 989 at 80.

Also new in the 1978 Bankruptcy Reform Act was section 523(a)(2)(B). This section now requires that creditors who attempt to except a debt from discharge based upon a false financial statement establish that they reasonably relied upon the statement. S. Rep. No. 989 at 78 (emphasis added).

The "fresh start" policy permeates the Bankruptcy Code and is an important factor in construing its various provisions, including discharge. See, e.g., *In re McNeely*, 82 B.R. 628, 632 (Bankr. S.D. Ga. 1987) (Congress' purpose in enacting section

525 was to enforce the fresh start doctrine); *In re Klein*, 64 B.R. 372 (Bankr. E.D.N.Y. 1986) (denying motion by creditor to extend time to file a complaint objecting to discharge); *In re Neiheisel*, 32 B.R. 146 (Bankr. D. Utah 1983) (the fresh start doctrine is effectuated through the section 522 exemptions);<sup>20</sup> *In re Shamblin*, 18 B.R. 800, 802 (Bankr. S.D. Ohio 1982) (section 525 of the Bankruptcy Code was intended to codify the fresh start doctrine). All of these decisions are consistent with this Court's pronouncement that "[t]he various provisions of the bankruptcy act were adopted in the light of [the fresh start policy] and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose and policy of the act." *Local Loan Co.*, 292 U.S. at 245.

A finding of nondischargeability is of crucial private and public importance. The values and interests at stake in dischargeability proceedings are not limited to the mere loss of money, and such proceedings are not the "typical civil case involving a monetary dispute between private parties" where "society has a minimal concern with the outcome . . . ." *Addington v. Texas*, 441 U.S. 418, 423 (1979). Because of the fresh start doctrine, more is at stake in a section 523 proceeding than "the general run of issues in civil cases" where the preponderance standard is appropriate. E. Cleary, *McCormick on Evidence* § 340 (3d ed. 1984). The fresh start policy militates in favor of application of a clear and convincing standard of proof in section 523(a)(2) proceedings.

#### C. Interpretation of Other Provisions of the Bankruptcy Code Is Consistent With Application of the Clear and Convincing Standard in Section 523(a)(2) Proceedings

In interpreting the Bankruptcy Code, courts "must not be guided by a single sentence or member of a sentence, but look

<sup>20</sup> *Neiheisel* undertakes an exhaustive analysis and review of the fresh start policy and the legislative history surrounding the "fresh start". *In re Neiheisel*, 32 B.R. 146, 157-62 (Bankr. D. Utah 1983).

to the provisions of the whole law, and to its object and policy." *Kelly v. Robinson*, 479 U.S. 36, 43 (1986). See also *United Savings Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988) ("A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme . . . because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law."). Moreover, "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific." *Midatlantic Nat'l Bank v. New Jersey Dep't of Env'tl. Protection*, 474 U.S. 494, 501 (1986) (citation omitted). There is no legislative history suggesting that Congress intended a lesser standard to prove fraud in a section 523(a)(2) discharge case than was traditionally required to prove fraud in civil cases at the time of the Code's adoption.

A finding of fraud is central to the fraudulent transfer provision of the Bankruptcy Code, 11 U.S.C. § 548(a)(1), which provides:

- (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
  - (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted;

11 U.S.C. § 548(a)(1) (1988) (emphasis added). In litigation under this section, bankruptcy courts consistently have applied the clear and convincing evidence standard. See, e.g., *In re Willson Dairy Co.*, 30 B.R. 67, 70 (Bankr. S.D. Ohio 1981) ("As is true of other causes of action for fraud under the Bankruptcy Code, § 548(a)(1) requires a party to prove actual

fraud by clear and convincing evidence"); *Phillips v. Wier*, 328 F.2d 368, 371 (5th Cir. 1964). See generally 4 L. King, M. Cook, R. D'Agostino & K. Klee, *Collier On Bankruptcy* ¶ 548.10 n.1 (15th ed. 1990).

A finding of fraud also is one of the grounds for appointment of a trustee in a Chapter 11 case. Section 1104 of the Code provides:

(a) At any time after the commencement of the case but before confirmation of a plan . . . the court shall order the appointment of a trustee—

(1) for cause, including *fraud*, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management . . . .

11 U.S.C. § 1104(a)(1) (1988) (emphasis added). The few cases that have addressed the burden of proof under section 1104, as well as the leading treatise, agree that clear and convincing evidence must be presented to justify the appointment of a trustee. See, e.g., *In re St. Louis Globe-Democrat, Inc.*, 63 B.R. 131 (Bankr. E.D. Mo. 1985); 5 L. King, C. Cyr, K. Klee, H. Minkel and W. Taggart, *Collier On Bankruptcy* ¶ 1104.01[7][b] (15th ed. 1990).

Amici point to the legislative history of 11 U.S.C. § 727 as suggesting that Congress intended the preponderance standard to apply under section 523(a). Section 727(a)(4) describes certain fraudulent conduct that will preclude a debtor's discharge in its entirety, including the making of a false oath or account, a false claim, the giving or receiving of money for acting or forbearing to act, or withholding of information. 11 U.S.C. § 727(a)(4) (1988). The legislative history cited by amici is found in certain House and Senate Reports referencing section 727(a)(4), and states in part: "[This] ground for denial of discharge is the commission of a bankruptcy crime, though the standard of proof is preponderance of the evidence rather than proof beyond a reasonable doubt." H.R. Rep. No. 595 at 384; S. Rep. No. 989 at 98.

Amici cite no case where the preponderance standard actually has been applied to section 727(a)(4) proceedings, and none holding that the legislative history of section 727(a)(4) has any bearing on the burden of proof requirements under section 523(a)(2). In fact, virtually every court attempting to interpret this sketchy legislative history has rejected it because of its inconsistency with all other applicable law. These courts instead have applied the clear and convincing standard. See, e.g., *In re Portner*, 109 B.R. 977, 980 (Bankr. D. Colo. 1989) ("this legislative history speaks not of setting a standard of proof, but instead, apprises us that a false oath case, although akin to perjury, need not be tested by the traditional criminal standard of proof beyond a reasonable doubt"); *In re Mayo*, 94 B.R. 315, 327 (Bankr. D. Vt. 1988) (reaching the same conclusion as *Portner* after finding that the legislative history is "sparse and . . . inconclusive"); *In re Garcia*, 88 B.R. 695, 701 (Bankr. E.D. Pa. 1988) (reaching the same conclusion as *Portner* and noting that it is "unclear whether Congress ever considered the intermediate standard traditional for fraud—i.e., clear and convincing evidence.").<sup>21</sup> It also is possible that Congress

<sup>21</sup> See also *In re Zell*, 108 B.R. 615, 623 (Bankr. S.D. Ohio 1989); *In re Erdman*, 96 B.R. 978, 984 (Bankr. D.N.D. 1988); *In re Dias*, 95 B.R. 419, 421 (Bankr. N.D. Tex. 1988); *In re Catignola*, 87 B.R. 702, 706 (Bankr. M.D. Fla. 1988); *In re Montgomery*, 86 B.R. 948, 955 (Bankr. N.D. Ind. 1988); *In re Johnson*, 82 B.R. 801, 804 (Bankr. E.D.N.C. 1988); *In re Booth*, 70 B.R. 391, 394 (Bankr. D. Colo. 1987); *In re Woerner*, 66 B.R. 964, 972 (Bankr. E.D. Pa. 1986); *In re Crawford*, 65 B.R. 378, 380 (Bankr. C.D. Cal. 1986); *In re Cohen*, 47 B.R. 871, 874 (Bankr. S.D. Fla. 1985); *In re Barrett*, 2 B.R. 296, 298 (Bankr. E.D. Pa. 1980). Many of these opinions cite to *Oriel v. Russell*, 278 U.S. 358 (1929), the subject matter of which would involve a section 727(a)(3) proceeding under the current Code. See, e.g., *In re Portner*, 109 B.R. at 983. The *Oriel* Court held that a contempt proceeding regarding a turnover order for books and records was a charge equivalent to fraud and must be established by clear and convincing evidence. *Oriel*, 278 U.S. at 362. One case that appears to hold that the preponderance of the evidence standard applies in section 727(a)(4) cases is *In re Parker*, 85 B.R. 384 (Bankr. E.D. Va. 1988). However, the same court, less than one year later, held that: "[F]or the purposes of fraudulent intent or fraud claims, the correct burden of proof is clear and convincing evidence. However, where fraud is not alleged, as in section 727(a)(3) claims, the correct burden of proof is a preponderance of the evidence." *In re Kim*, 97 B.R. 275, 281 (Bankr. E.D. Va. 1989).

merely considered the clear and convincing standard as a more demanding formulation of the preponderance standard applicable to certain issues. *Garcia*, 88 B.R. at 701.

Moreover, the conclusion that amici suggest is inconsistent with Bankruptcy Rule 4005 which "leaves to the courts" the evidentiary degree that an objecting creditor must sustain. 11 U.S.C. Rule 4005, Advisory Committee Note (1988). The inference suggested by amici also would be contrary to the uniform interpretation of 11 U.S.C. § 548(a)(1), which calls for "clear and convincing evidence" to prove a fraudulent transfer under the Code. *In re Bucci*, 97 B.R. 954, 957 (Bankr. N.D. Ill. 1989) (proof of "actual fraud" under either section 727(a)(2) or section 548(a)(1) must be by clear and convincing evidence).

Finally, the grounds for a complete denial of discharge under section 727 generally involve misconduct or fraud upon all creditors, or upon the court itself, within the confines of the bankruptcy proceeding. Congress may well have intended to prescribe a lower standard of proof under section 727(a)(4) than under section 523(a)(2) because the latter involves fraud with respect to the creation of a debt vis-a-vis one creditor only; it does not involve fraud upon the court or the bankruptcy process.

In light of the existing law regarding the burden of proof in fraud cases and the objectives and purposes of the Bankruptcy Code, the inconclusive legislative history found in the House and Senate Reports regarding section 727 must be rejected.

## II. A PRIOR CIVIL JUDGMENT OF FRAUD BASED UPON A PREPONDERANCE STANDARD OF PROOF DOES NOT COLLATERALLY ESTOP LITIGATION OF FRAUD ISSUES IN A SECTION 523(a)(2) PROCEEDING

In *Cromwell v. County of Sac.*, 94 U.S. 351 (1876), the Court explained the difference between res judicata (claim preclusion) and collateral estoppel (issue preclusion):

[T]here is a difference between the effect of a judgment as a bar or estoppel against the prosecution of a second action upon the same claim or demand, and its effect as

an estoppel in another action between the same parties upon a different claim or cause of action . . . .

[W]here the second action between the same parties is upon a different claim or demand, the judgment in the prior action operates as an estoppel only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered.

*Id.* at 352-53. Issue preclusion operates only with respect to individual legal and factual issues, not claims or causes of action. *Montana v. United States*, 440 U.S. 147, 153 (1979).

This Court has rejected application of res judicata in bankruptcy discharge proceedings. *Brown v. Felsen*, 442 U.S. 127 (1979). However, the Court did not prescribe a specific rule for the application of collateral estoppel:

If, in the course of adjudicating a state-law question, a state court should determine factual issues using standards identical to those of § 17 [of the 1898 Bankruptcy Act], then collateral estoppel, *in the absence of countervailing statutory policy*, would bar relitigation of those issues in the bankruptcy court.

*Id.* at 139 n.10 (emphasis added).

The courts and commentators appear to be split on the issue of whether collateral estoppel should apply in subsequent bankruptcy discharge actions. See *Spillman v. Harley*, 656 F.2d 224, 227-28 (6th Cir. 1981); *Carey Lumber Co. v. Bell*, 615 F.2d 370, 377-78 (5th Cir. 1980). *In re Ross*, 602 F.2d 604, 607-08 (3d Cir. 1979); *In re Black*, 18 B.R. 534 (Bankr. D.N.M. 1982); 3 L. King, R. Babitt, A. Herzog & R. Levin, *Collier on Bankruptcy* ¶ 523.11 (15th ed 1990); Ferriell, *The Preclusive Effect of State Court Decisions in Bankruptcy* (Second Installment), 59 Am. Bankr. L.J. 55 (1985); Ferriell, *The Preclusive Effect of State Court Decisions in Bankruptcy* (First installment), 58 Am. Bankr. L.J. 349 (1984).

Prior to the Court's opinion in *Brown v. Felsen*, the Ninth Circuit took a different approach in *In re Houtman*, 568 F.2d 651, 655 (9th Cir. 1978). The court held that a prior state court judgment has no collateral estoppel effect in a subsequent bank-

ruptcy court proceeding, but that it can establish a prima facie case of nondischargeability.

In light of (1) the exclusive jurisdiction given to bankruptcy courts to determine dischargeability under sections 523(a)(2) and (2) the all-encompassing fresh start policy of the Bankruptcy Code, Respondent urges that if collateral estoppel applies in section 523(a) bankruptcy discharge proceedings, that its scope be limited to ensure that it does not encroach upon the "countervailing statutory policy" of the fresh start doctrine.

If collateral estoppel applies in bankruptcy discharge proceedings, it applies only where each element set forth in the Restatement (Second) of Judgments § 27 is satisfied. Consistent with the Court's holdings in *Cromwell* and *Montana*, section 27 of the Restatement lists three prerequisites for collateral estoppel:

- (1) the issue actually was litigated in the first suit;
- (2) the issue must have been determined by a valid and final judgment; and
- (3) determination of the issue was essential to the prior judgment.

Restatement (Second) of Judgments § 27 (1982).

If, however, the burden of proof for the issue is substantially higher in the second action than in the first, there is no identity of issues and collateral estoppel does not apply. 18 C. Wright, A. Miller, & E. Cooper, *Federal Practice and Procedure* § 4422 at 209-12, 214-15 (1981 & Supp. 1990); Restatement (Second) of Judgments § 28(a)(4). Amici acknowledge this basic rule. Brief of amici curiae at 10 n.5. The drafters of the Restatement incorporated this concept into section 28(a):

Although an issue is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, relitigation of the issue in a subsequent action between the parties is not precluded [when]...[t]he party against whom preclusion is sought

had a significantly heavier burden of persuasion with respect to the issue in the initial action than in the subsequent action; the burden has shifted to his adversary; or the adversary has a significantly heavier burden than he had in the first action.

Restatement (Second) of Judgments § 28(a)(4) (1982). See also *id.*, comment f, illustration 11 (the clear and convincing standard is sufficiently heavier than the preponderance of the evidence standard to trigger section 28). The Ninth Circuit has recited the principle thus: "It is an elementary principle of issue preclusion that it may only be asserted where the burden of proof as to that issue is no greater than it was in the prior proceeding where the issue was decided." *United States v. Rylander*, 714 F.2d 996, 1002 (9th Cir. 1983), cert. denied, 467 U.S. 1209 (1984). See also *O'Shea v. Amoco Oil Co.*, 886 F.2d 584 (3d Cir. 1989).

In most cases involving different burdens of proof, the plaintiff in the prior action failed to carry a heavier burden than that required in the subsequent proceeding. Defendant then seeks to preclude plaintiff from reasserting the same claim in a subsequent action in which a lower standard of proof applied. The most common example is where the government fails to prove a criminal wrong beyond a reasonable doubt and the same defendant in a subsequent civil suit attempts to preclude relitigation of the issue on the basis of collateral estoppel. See, e.g., *One Lot Emerald Cut Stones v. United States*, 409 U.S. 232, 235 (1972) (an acquittal on criminal charges "does not constitute an adjudication on the preponderance-of-the-evidence burden applicable in civil proceedings"); *Bullock v. Pearson*, 768 F.2d 1191, 1193 (10th Cir. 1985), cert. denied, 474 U.S. 1086 (1986) (dicta stating that failure to establish fraud by clear and convincing evidence would not preclude relitigation of the issue if a lower standard of proof were applicable in a subsequent action); *Helvering v. Mitchell*, 303 U.S. 391, 405-06 (1938); *Murphy v. United States*, 272 U.S. 630, 632-33 (1926); *Stone v. United States*, 167 U.S. 178, 189 (1897).

If the failure to carry a higher standard, e.g., clear and convincing, in the first action does not constitute an adjudication on the lower standard, e.g., preponderance of the evidence, then it follows that carrying the issue by the preponderance standard does not constitute an adjudication under the clear and convincing standard.<sup>22</sup> Accordingly, application of collateral estoppel in the instant bankruptcy proceeding is improper, Restatement (Second) of Judgments § 28(a)(4) (1982); 18 C. Wright, A. Miller, & E. Cooper, *Federal Practice and Procedure* § 4422, at 214-15 (1981 & Supp. 1990), because Petitioners are required to prove fraud by clear and convincing evidence in a section 523(a)(2) discharge proceeding.

<sup>22</sup> In *United States v. Beery*, 678 F.2d 856 (10th Cir. 1982), cert. denied, 471 U.S. 1066 (1985), the court of appeals stated:

A defendant in a criminal case is not collaterally estopped from raising issues that were determined against him in a prior civil action. In view of the different degrees of proof in civil and criminal cases, the adjudication of a fact in a civil proceeding is not binding in a criminal case under principles of collateral estoppel.

*Id.* at 868 n.10 (citing *United States v. Konovsky*, 202 F.2d 721, 726-27 (7th Cir. 1953)). See also *Ferrel v. Pierce*, 785 F.2d 1372, 1378 n.2 (7th Cir. 1986) (heavier burden of proof precludes application of collateral estoppel); *Newport News Shipbuilding & Dry Dock Co. v. Director, Office of Workers' Compensation Programs*, 583 F.2d 1273, 1278 (4th Cir. 1978), cert. denied, 440 U.S. 915 (1979); *Young & Co. v. Shea*, 397 F.2d 185, 188-89 (5th Cir. 1968), cert. denied, 395 U.S. 920 (1969).

## CONCLUSION

The judgment of the court of appeals should be affirmed.

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No. 89-1149

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Supreme Court, U.S.  
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In The  
Supreme Court of the United States  
October Term, 1990

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COY R. GROGAN AND JOHN H. HENSON,  
*Petitioners,*  
v.

FRANK J. GARNER, JR.,  
*Respondent.*

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On Writ Of Certiorari To The United States  
Court Of Appeals For The Eighth Circuit

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REPLY BRIEF FOR THE PETITIONERS

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No. 89-1149

In The

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COY R. GROGAN AND JOHN H. HENSON,  
*Petitioners,*

v.

FRANK J. GARNER, JR.,

*Respondent.*

On Writ Of Certiorari To The United States  
 Court Of Appeals For The Eighth Circuit

REPLY BRIEF FOR THE PETITIONERS

ARGUMENT

- I. THE COMMON LAW EXISTING AT THE TIME THE BANKRUPTCY CODE WAS ENACTED DOES NOT SUPPORT THE RESPONDENT'S CLAIM THAT CONGRESS INTENDED A "CLEAR AND CONVINCING" STANDARD OF PROOF UNDER § 523(a)(2).

Respondent argues that this Court must presume that Congress intended to maintain continuity with the "judicial practice" existing at the time of enactment of the Bankruptcy Code in 1978. From this assertion follows the

argument that Congress must have intended a clear and convincing standard of proof in the context of § 523(a)(2) because a "significant majority" of states required that fraud be proven by clear and convincing evidence.

Respondent's assertion that a "significant majority" of fraud cases required the clear and convincing standard in 1978 is incorrect. Respondent claims that cases from 34 states held that more than a preponderance of the evidence was required in civil fraud cases at common law when § 523(a)(2) was adopted. Respondent's Brief at 12 n. 6.

The authorities in five of the jurisdictions cited by respondent recite the familiar equitable maxim that a written instrument or legal relationship will not be set aside for fraud without clear or unequivocal proof.<sup>1</sup> Indeed, much of the confusion in this area stems from the chancery courts' imposition of a more demanding standard of proof in such cases where claims of fraud were unenforceable at law and the concern for fabrication of the fraud claim was high. As this Court has observed,

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<sup>1</sup> The authorities cited by respondent from Illinois, Minnesota, New Jersey, New Mexico and Oklahoma are grounded on the equity principle that fraud sufficient to set aside a presumptively valid written instrument or status conferred by law must be established by clear and convincing evidence. *Ray v. Winter*, 67 Ill. 2d 296, 367 N.E. 2d 678 (1977) (action to impose a constructive trust); *Weise v. Red Owl Stores, Inc.*, 286 Minn. 199, 175 N.W. 2d 184 (1970); *Bilowit v. Dolitsky*, 124 N.J. 101, 304 A.2d 774 (Super. 1973) (action to annul marriage based on fraud); *Rael v. Cisneros*, 82 N.M. 705, 487 P.2d 133 (1971) (quiet title action testing validity of deed); *Daubert v. Mosley*, 487 P.2d 353 (Okla. 1971) (action to set aside minor's release).

these kinds of cases "bear little relationship to modern lawsuits under the federal securities laws." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388 n. 27 (1983). The instant action involves the question of the non-dischargeability of a debt which arose from a money judgment obtained in an earlier lawsuit involving a claim of common law fraud in the sale of securities.

In four other jurisdictions relied upon by respondent, the cases cited actually hold that the proper standard of proof is the preponderance standard,<sup>2</sup> and two other jurisdictions cited by respondent recite the clear and convincing standard while deciding the case on other grounds.<sup>3</sup> In fact, the "significant majority" rule asserted by respondent was followed in less than half the states when the Bankruptcy Code was enacted in 1978. Thus, respondent's argument that § 523(a)(2) should be interpreted in light of the common law and the scheme of

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<sup>2</sup> The cases cited by respondent from Iowa, Kansas, South Carolina and Texas do not support the proposition that a heightened standard of proof applies in civil fraud actions. These cases hold expressly that the proper quantum of proof required in a civil fraud case is a preponderance of the evidence. *Hall v. Wright*, 261 Iowa 758, 156 N.W. 2d 661 (1968); *Fox v. Wilson*, 211 Kan. 563, 507 P.2d 252 (1973); *Gilbert v. Mid-South Machinery Co., Inc.*, 267 S.C. 211, 227 S.E. 2d 189 (1976); *Frankfurt v. Wilson*, 353 S.W. 2d 490 (Tex. Civ. App. 1961).

<sup>3</sup> The Michigan and Nebraska authorities cited by respondent recite in *dicta* the principle that fraud must be proven with clear and convincing evidence, but the decisions rest on other grounds. *Hi-Way Motor Co. v. International Harvester Co.*, 398 Mich. 330, 247 N.W. 2d 813 (1976) (fraud may not be based on promises of future action); *Page v. Andreasen*, 200 Neb. 641, 264 N.W. 2d 682 (1978) (appeal from grant of summary judgment for a defendant not a real party in interest).

jurisprudence existing at the time of the enactment does not support the argument that Congress intended to impose an extraordinary, higher standard of proof in nondischargeability proceedings in bankruptcy.

In addition, it is important to maintain the distinction between an adjudication of common law fraud which is determined by the fact-finder under the prevailing state standard of proof and the determination of nondischargeability which arises ordinarily after the existence of the fraud debt has been adjudicated. Section 523 of the Code provides a number of exceptions to the general discharge of debts arising ordinarily from bankruptcy. Respondent has offered no cogent reason why a creditor with an existing fraud judgment against a bankrupt debtor must prove that the debt is within the fraud exception to discharge with a quantum of evidence greater than required to obtain the fraud judgment in the first instance.

There is utility in determining nondischargeability with the same degree of assurance of reliability as required in the underlying proceeding to establish the debt. *In re Braen*, 900 F.2d 621, 625 (3d Cir. 1990). This utility may be achieved by adopting the preponderance standard in nondischargeability cases. In those instances where the preponderance rule applies in the underlying fraud case seeking monetary damages, the waste of judicial resources occasioned by a relitigation of the issues in bankruptcy court is avoided. *Cf. In re Braen*, 900 F.2d at 625. Where the underlying claim requires the heightened standard of proof of fraud, the debtor receives the benefit of that protection because there can be no "debt" to

discharge unless the greater standard of proof is met initially as the fraud claim is adjudicated.

**II. THE FRESH START POLICY OF THE CODE DOES NOT WARRANT APPLICATION OF THE CLEAR AND CONVINCING STANDARD AND APPLICATION OF SUCH STANDARD WOULD IMPROPERLY PREFER THE DEBTOR'S INTERESTS OVER A DEFRAUDED CREDITOR'S INTERESTS.**

**A. THE DEBTOR'S INTEREST IN A FRESH START IS NOT SUFFICIENTLY IMPORTANT TO WARRANT APPLICATION OF THE CLEAR AND CONVINCING STANDARD.**

The general rule in civil litigation is that the parties need only prove their case by a preponderance of the evidence. *See Price Waterhouse v. Hopkins*, \_\_\_ U.S. \_\_\_, 109 S. Ct. 1775, 1792 (1989). *See also Huddleston*, 459 U.S. at 390 (1983) ("the preponderance-of-the-evidence standard [is] generally applicable in civil actions"). Exceptions to this standard are uncommon, and in fact are ordinarily recognized only when the government seeks to take unusual coercive action – action more dramatic than entering an award of money damages or other conventional relief – against an individual. *Price Waterhouse*, 109 S. Ct. at 1792.

In this case respondent asks the Court to create an exception to the general rule that the preponderance of the evidence standard applies in civil cases. Respondent's justification for this exception is that a central purpose of the Bankruptcy Code is to afford a debtor a "fresh start". Respondent believes that the public and private interests

implicated by the debtor obtaining this fresh start (effected through the discharge provisions of Code § 727) transcend the interests involved in a typical civil case. Indeed, respondent claims that the debtor's interest in a fresh start, which is at stake during a nondischargeability proceeding, is of "crucial private and public importance."

Petitioners do not challenge the proposition that a "fresh start" is a central purpose of the Code. See *Lines v. Frederick*, 400 U.S. 18, 19 (1970). Nor do petitioners quarrel with the principle that the debtor has an important personal interest in obtaining a discharge. See *United States v. Kras*, 409 U.S. 434, 445 (1972). However, the present case does not concern whether respondent is generally entitled to a discharge; rather, the issue is simply whether petitioners have adequately proved the statutory exception to discharge embodied in Code § 523(a)(2). Reference to the "fresh start" policy underlying the Code provides no help in determining what Congress intended regarding standards of proof in a nondischargeability case. See *In re Braen*, 900 F.2d at 625. The observation that a finding of nondischargeability prevents the debtor from obtaining a fresh start "provides little assistance in construing a section expressly designed to make some debts nondischargeable". *United States v. Soletto*, 436 U.S. 268, 280 (1978).

Where Congress has not prescribed the appropriate standard of proof and the Constitution does not dictate a particular standard, the Court must prescribe one. *Hudleston*, 459 U.S. at 389. Clearly, Congress has not stated the appropriate standard of proof to be applied in a

nondischargeability proceeding. Thus, it must be determined whether a standard is dictated by the Constitution. It appears that respondent believes that his interest in a discharge is of sufficient importance to merit constitutional protection.

Respondent cites *Addington v. Texas*, 441 U.S. 418 (1979) in support of his proposition that "more is at stake in a section 523 proceeding than the general run of issues in civil cases where the preponderance standard is appropriate." Respondent's Brief at 26. *Addington* concerns the standard of proof required to commit a person to a state mental hospital. The Court found that the individual's interest in the outcome of a civil commitment proceeding is of such weight and gravity that due process requires "proof more substantial than a mere preponderance of the evidence." See *Addington*, 441 U.S. at 427. Noting that the highest standard of proof, proof beyond a reasonable doubt, was usually not appropriate except in criminal cases, the Court found that the intermediate standard of clear and convincing proof fairly balanced the rights of the individual and the interests of the state. See *Addington*, 441 U.S. at 431.

In *Addington* the Court cited other cases involving "particularly important individual interests" in which constitutional due process mandated application of the clear and convincing standard.<sup>4</sup> See *Addington*, 441 U.S.

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<sup>4</sup> The Court also observed that the clear and convincing standard is applied in civil fraud cases. However, as discussed in the preceding section of this brief and in petitioners' original brief on the merits (Petitioners' Brief at 16), such observation was merely dicta and contrary to the standard of proof actually applied in a majority of jurisdictions.

at 424, citing *Woodby v. INS*, 385 U.S. 276 (1966) (deportation); *Chaunt v. United States*, 364 U.S. 350 (1960) (denaturalization); and *Schneiderman v. United States*, 320 U.S. 118 (1943) (denaturalization). One could add to this list *Santosky v. Kramer*, 455 U.S. 745 (1982) (termination of parental rights); and *Cruzan v. Director, Missouri Department of Health*, \_\_\_ U.S. \_\_\_, 110 S. Ct. 2841 (1990) (withholding of nutrition and hydration from a person in a persistent vegetative state).

*Addington*, however, is completely inapposite to the present case because respondent's interests at stake in this case are qualitatively different (and constitutionally less important) than the individual interests considered in *Addington*. In *Addington* and each of the foregoing cases the interests involved were found to be "both 'particularly important' and 'more substantial than mere loss of money' ", *Cruzan*, 110 S. Ct. 2853, quoting *Santosky*, 455 U.S. at 756, and therefore, it was determined that protection of these interests by a heightened standard of proof was constitutionally required. These cases stand in sharp contrast to the present case which considers merely a debtor's interest in avoiding satisfaction of a fraud debt through a discharge in bankruptcy.

A discharge in bankruptcy is a privilege, which Congress may grant with conditions or withhold altogether. See *In re Lah*, 88 Bankr. 141, 145 (Bkrtcy. N.D. Ohio 1988); *In re Roedel*, 34 Bankr. 689, 694 (D. N.J. 1983). A discharge is a legislatively created benefit, not a constitutional one; there is no constitutional right to obtain a discharge of one's debts in bankruptcy. See *Kras*, 409 U.S. at 446.

In *Kras* the Court recognized that although the debtor's personal interests in obtaining a bankruptcy discharge were "important", such interests did not rise to the same constitutional level of "particularly important individual rights or interests" involved, for example, in obtaining a divorce:

If *Kras* is not discharged in bankruptcy, his position will not be materially altered in any constitutional sense. Gaining or not gaining a discharge will effect no change with respect to basic necessities. We see no fundamental interest that is gained or lost depending on the availability of a discharge in bankruptcy. *Kras*, 409 U.S. at 445.

The Court went on to observe, "government's role with respect to the private commercial relationship is qualitatively and quantitatively different from its role in the establishment, enforcement, and dissolution of marriage." *Kras*, 409 U.S. at 445-446.

The Court could scarcely have been clearer that there is no constitutionally protected interest involved in obtaining a discharge. Instead, the issue of discharge simply involves a private commercial relationship between the debtor and a creditor. It would be inappropriate to "constitutionalize" what is simply a monetary dispute between private parties. See, *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 761 n. 7 (1985) (attempted implication of First Amendment rights in a private libel dispute would "constitutionalize the entire law of libel.") Accordingly, because there is no constitutional protection afforded to the debtor's interest in a discharge, there is no basis for protecting this interest by a heightened standard of proof.

Lacking any congressional direction or constitutional mandate requiring application of the clear and convincing standard, the general rule of preponderance of the evidence applies. Such conclusion is consistent with *Huddleston* which holds that imposition of even severe civil sanctions which do not implicate particularly important individual interests is permitted upon proof by a preponderance. See *Huddleston*, 459 U.S. at 389-390.

*Huddleston* cites the following cases in which the consequences to the individual were quite severe, but because no constitutionally important rights were involved, the preponderance standard was found appropriate: *United States v. Regan*, 232 U.S. 37 (1914) (proof of acts exposing a party to criminal prosecution); *Steadman v. SEC*, 450 U.S. 91 (1981) (sanctions under the Investment Advisors Act, including permanently barring an individual from practicing his profession); and *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (establishment of fraud under § 17(a) of the Securities Act of 1933). *Huddleston* found that securities fraud under § 10(b) of the Securities Exchange Act of 1934 could be proved by a preponderance. Subsequent to *Huddleston*, the Court ruled that despite the "serious economic consequences" to the defendant, paternity could be established by a preponderance of the evidence. See *Rivera v. Minnich*, 483 U.S. 574 (1987).

Thus, although a ruling that respondent's debt to petitioners is nondischargeable may have serious economic effects on respondent, such consideration is not useful in selecting the appropriate burden of proof. See *Soletto*, 436 U.S. at 280. This case is, at its most fundamental level, simply a dispute over respondent's payment of a

debt. No constitutionally important interest is implicated in such a dispute, and accordingly, the preponderance standard is applicable.

#### B. APPLICATION OF THE CLEAR AND CONVINCING STANDARD IMPROPERLY PREFERS THE DEBTOR'S INTERESTS OVER THE CREDITOR'S INTERESTS.

The standard of proof serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision. *Addington*, 441 U.S. at 423. A preponderance-of-the-evidence standard allows both parties to share the risk of error in roughly equal fashion. Any other standard expresses a preference for one side's interests. *Huddleston*, 459 U.S. at 390. Adoption of a requirement that a creditor must prove exceptions to discharge by clear and convincing evidence would be an expression of a preference for the debtor's interest in a discharge over a defrauded creditor's interest in receiving compensation. Such a preference is not justified.

The discharge granted by the Code was intended to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes . . . [the bankruptcy act] gives the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). Congress recognized the importance of the fresh start by enacting the Code. See *Kras*, 409 U.S. at 445.

However, the present case does not involve an "honest but unfortunate debtor" who has suffered "business misfortunes". This is a case of a debtor whom a jury has found committed willful fraud with sufficient malice to warrant punitive damages. The solicitude of Congress stops at the debtor who does not measure up to the standard of an "honest but unfortunate debtor" and who has engaged in grossly irresponsible or fraudulent conduct. See *In re Howard*, 55 Bankr. 580, 583 (Bkrtcy. 1985), quoting Riesenfield, *Creditors' Remedies and Debtors' Protection* 729 (3d ed. 1979).

Congress was not required to enact any exceptions to discharge. See generally *Kras*, 409 U.S. at 447. By creating these exceptions Congress has clearly indicated that there is a strong policy against permitting certain debtors to avoid responsibility for their malicious conduct:

Congress had reasons for enacting the exceptions to discharge. . . . While bankruptcy proceedings are intended to afford debtors a 'fresh start', the provision here expresses Congress' determination that debts incurred as the result of a debtor's willful and malicious injury of another are of a type that bankruptcy ought not to forgive. *Combs v. Richardson*, 838 F.2d 112, 116 (4th Cir. 1988).

See also *In re Braen*, 900 F.2d at 625 ("the non-dischargeability exceptions reflect Congress' belief that debtors do not merit a fresh start to the extent that their debts fall within § 523").

Congress has created a statutory system which already tends to favor the debtor by requiring the creditor to bear the burden of proving the debt is not dischargeable, rather than the debtor proving the debt is

dischargeable. There is no basis, however, for finding that Congress determined that defrauded creditors were entitled to relief under Code § 523, and yet decided to decrease the likelihood that such relief would be granted by heightening the standard of proof. Instead, it is evident that Congress has determined there are competing policies involved in a nondischargeability case: the debtor's interest in a discharge and the defrauded creditor's right to compensation. In light of *Kras*' finding that a discharge in bankruptcy does not implicate a fundamental interest of the debtor, it appears clear that Congress did not find either interest to be more important or entitled to special protection. Where the interests at stake are equal, the appropriate standard of proof is that normally applied in private litigation, proof by a preponderance of the evidence. See *Rivera*, 483 U.S. at 581. A heightened standard of proof is not justified to prove a Code § 523 exception to discharge. See *Combs*, 838 F.2d at 116. Accordingly, in the present case, where the competing interests are equal, the Court of Appeals erred in requiring proof by clear and convincing evidence.

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**CONCLUSION**

For the foregoing reasons, petitioners request that the judgment of the Court of Appeals be reversed and the case be remanded to the District Court for entry of judgment in petitioners' favor on the claims under § 523(a)(2) of the Bankruptcy Code.

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